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**Augmenting Employee Protection during Hostile
Takeovers of Private Sector Companies in China:
Lessons from the German Co-determination Model**

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Abstract

China is currently undergoing a wave of corporate takeovers and accordingly, hostile takeovers are projected to rise. The term “corporate takeover” is a reference to the “means of one company acquiring control over another,” whilst hostile takeovers are those opposed by the incumbent management of target firms. In hostile takeovers, workers are especially vulnerable to adverse treatments by the new managerial team. The thesis uses three theories to examine this vulnerability. First, the new management tends to seek to improve the efficiency of the acquired firm, sometimes at the expense of the workers’ interests. Second, hostile takeovers constitute the breach of implicit contracts between the employer and employees of the target firm. The implicit contract is maintained based on the workers’ trust in the incumbent management. This breach of trust leads to the shareholders’ expropriation of the employees’ wealth. Third, it is generally agreed that Chinese firms adopt the corporate governance model of shareholder primacy, which inappropriately prioritises shareholder interests over other stakeholders, including the employees. Therefore, workers are in urgent need of a mechanism that can safeguard their interests.

On the other hand, the thesis uses approaches of theoretical analysis and qualitative studies to argue that better employee protection positively relates to firm value. This can be examined using the development of corporate governance models that are distinguished from shareholder primacy. For instance, according to enlightened shareholder value, to protect workers’ interests positively relates to the long-term value of the firm and shareholders. Moreover, the stakeholder theory highlights their importance in corporate governance, which arises from business ethics and its functions in value creation. In this case, workers’ interests deserve to be considered in hostile takeovers. From the economic perspective, an enhanced labour protection and involvement mechanism in takeovers is expected to usher in benefits from three perspectives. First, an enhanced employee protection and involvement mechanism is expected to improve employees’ productivity, which positively relates to firm value. Second, in the face of uncertainties and risks of a breach of implicit contracts, employees tend to be reluctant to invest in firms, adversely affecting firm value. An

enhanced employee protection mechanism and deeper employee participation in takeovers may effectively impede this problem. Third, in hostile takeovers, the employees' involvement in the takeover decision can reduce the leeway for managerial opportunism, which reduces the shareholder-manager agency costs. Additionally, it helps establish high trust workplace relationships, which reduce the employer-employee agency costs.

Since employees are vulnerable to adverse treatments in takeovers and improving worker's protection and participation is positively related to firm value, it is necessary to establish an effective mechanism in Chinese firms, especially considering that institutions such as trade unions and the Workers' Congress were embedded in the old planned economy and cannot be adjusted into modern corporate governance. This thesis attempts to draw lessons from the German co-determination mechanism to resolve the Chinese problems by adopting the approach of "legal transplants."

The grounds for the introduction of the German co-determination mechanism can be examined from the perspective of Chinese economic development. Under the varieties of contexts of capitalism which focus on the firms' coordination with other economic factors, Chinese firms are highly similar to their German counterparts, in terms of ways of coordination among firms and other institutions. However, they demonstrate a distinguished landscape in terms of worker's treatment. The Chinese employer-employee relationship leads to institutional incoherence, which hinders their economic transition to a more innovative one. The most direct and effective way to solve this issue is to alter the Chinese firm-worker relationship to that of the German style. This introduction of the German model is more likely to adhere to the Chinese economy. In addition, this compatibility with demands for economic development align with the interests of the party-state that have the dominant control over industrial relations in China. Therefore, this German system is more likely to be adopted.

It should be noted that German workers' co-determination rights exist at the board as well as the establishment levels. Inspired by this system, the thesis attempts to improve the Chinese mechanism at both levels. The thesis adopts a comparative study to

examine the difference of corporate structures and ideologies underlying corporate laws between these two countries. Thereafter, the thesis provides suggestions for certain adjustments in order to make the German model concurrent with the Chinese context.

Lay Summary

It is quite common in the securities market that a company (the acquiring company) acquire the control over the other (the target company). This is referred to as corporate takeovers. However, the management in the target company may resist some of the takeover offer, and these types of takeovers are called hostile takeovers.

After the completion of a hostile takeover, the uncooperative management are normally replaced, and the acquirer normally select new management. In order to improve the efficiency of the company after takeovers, the new management normally take a series of measures to cut the costs, which include massive lay-offs or reduction in wages. Due to the imbalance of powers between the management and employees, employees are vulnerable to adverse treatments, and therefore they need a mechanism to protect their interests. On the other hand, the mechanism that aims to safeguard workers' interests can positively affect the interests of the firm. This is because stronger protection of workers is expected to encourage workers work more productively, with less fear of possible adverse treatments in the near future. Therefore, a stronger employee protection mechanism is in urgent need by both employees and employers.

However, the mechanisms provided by Chinese laws does is ineffective, which can be evidenced by an increase in labour strikes arising from takeovers. The main reasons for the ineffectiveness are two-fold. First, the employee protection mechanism is under the control of the party-state, and therefore the extent to which workers can be protected depends the policy chosen by the party-state. The second is that these mechanisms were created in the old planned economy, which was coherent with organisational structure of the corporation at that time. However, when the modern corporate structure was introduced, these mechanisms became obsolete and incompatible with the modern corporate structure. Therefore, workers in Chinese companies need better mechanisms to safeguard their interests.

The thesis attempts to resolve the Chinese problems by borrowing the worker participation scheme for German laws. The reason to choose the German scheme as the model is its renowned strong employee protection. In addition, the thesis finds that the Chinese ways of treatment on workers negatively affect the national economy and the country's innovative capability. By introducing the German mechanism, these negative effects can also be alleviated. This means that the German ways of treatments on workers are coherent with the Chinese economic system.

The German system safeguard workers interests by providing two channels for workers to express their voices. The first is through workers' representatives on the board whilst the second is through the works council internal the firm. These mechanisms cannot be adopted by Chinese companies directly, because of the difference of organisational structures between Chinese and German firms. In addition, it should be noted that the law is embedded in the cultural, economic, political, and social background of its origins. Hence, there is a risk that the German mechanism cannot be well fit into the Chinese context. Therefore, certain modifications of the German scheme should be made to make it adapted into Chinese contexts.

To sum up, both employer and its employees are in need of a strong labour protection mechanism, but the protection of employees' interests is weak. In order to resolve Chinese problems, the thesis suggests borrowing rules from German laws.

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Pursuing a Ph.D. is a painful but rewarding experience. It is like climbing a mountain. I felt confident and energetic at the bottom and thought I could complete the journey easily. Halfway up the mountain, two dominant feelings accompanied me: frustration when I realised most of my energy had been used up but there was still a long way ahead and confusion when I had to choose a promising and practical pathway to move on in the unexplored territory. However, when the destination is in sight, I felt everything was rewarding. I am aware that I would not have gained this achievement without the valuable guidance and encouragement from some of the best mentors. As such, I would like to convey my gratitude to some of the most wonderful and caring persons.

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Table of Contents

Abstract	i
Lay Summary	iv
Acknowledgement	vi
Table of Contents	viii
Abbreviations and Acronyms	1
Introduction	2
1. Research Background	2
Hostile Takeovers: The Market for Corporate Control	2
Employee Vulnerability to Adverse Treatments in the Context of Takeovers ..	3
2. Research Questions and Methodologies	4
3. Structure of the Thesis	8
Chapter 1: The Vulnerability of Employees in Hostile Takeovers	10
1.1 Introduction to Hostile Takeovers in China	10
1.2 The Predicted Rise of Hostile Takeovers in China.....	13
1.3 The Vulnerability of Employees in Hostile Takeovers.....	18
1.3.1 Incentives to Improve the Efficiency of Target Companies	18
1.3.2 A Breach of Trust in Hostile Takeovers.....	23
1.3.3 Shareholder Primacy Theory.....	29
1.4 Conclusion.....	35
Chapter 2: Theoretical Foundations for Employee Protection and Participation in Hostile Takeovers	36
2.1 Challenges to Shareholder Primacy and other Corporate Governance Models	36
2.1.1 Enlightened Shareholder Value	42
2.1.2 Team Production Theory	44
2.1.3 Stakeholder Theory	47
2.1.4 German Firms' Approaches to Corporate Governance.....	53
2.1.5 Conclusion	59

2.2	Economic Grounds for Enhanced Employee Participation in Hostile Takeovers.....	61
2.2.1	Positive Correlation of Employee Involvement with Productivity and Firm Performance.....	62
2.2.2	Employee Participation to Forestall Hold-up Problems	66
2.2.3	Reducing Agency Costs	69
2.2.4	Conclusion	76
Chapter 3: Labour Participation Mechanisms in the Context of Hostile Takeovers in Chinese Firms.....		78
3.1	A Summary of the Legal Framework	78
3.2	The Workers' Congress.....	80
3.2.1	Introduction to the Workers' Congress.....	80
3.2.2	The Workers' Congress' Incompatibility with the Corporate Governance System in China	82
3.2.3	Conclusion	87
3.3	The Trade Unions	88
3.3.1	Introduction to the Trade Unions in China.....	88
3.3.2	The Dual Objectives of the Trade Union	89
3.3.3	A Lack of Independence from the Firm	93
3.3.4	Conclusion	95
3.4	Board Representation.....	95
3.5	To Resolve Chinese Problems by Legal Transplantation.....	98
3.6	Conclusion	102
Chapter 4: Justifying the Introduction of the German Co-Determination Model: the VoC Approach.....		104
4.1	An Introduction to the VoC Approach	105
4.2	The Chinese State Capitalist System under the VoC Approach.....	107
4.2.1	The State-owned Enterprises.....	108
4.2.2	Non-democratic Public Governance	110
4.2.3	An Analysis of the Chinese State Capitalist System through the VoC Lens	111
4.3	A Comparison of German CMEs and the Chinese Economy	112
4.3.1	The Dominant Forces in the German and Chinese Economies	114

4.3.2	Cross-Shareholdings Among Firms	117
4.3.3	Institutional Coordination.....	120
4.3.4	Interpersonal Relationships in the Economy.....	123
4.3.5	Conclusion	127
4.4	Grounds for Introducing the German Co-Determination Mechanism in Takeovers from the Perspective of China	128
4.4.1	Mixed Features of CMEs and LMEs in the Coordination of Chinese Firms	128
4.4.2	The Impact of Institutional Incoherence on the Economy	132
4.4.3	Institutional Incoherence of the Coordination of Chinese Firms	134
4.4.4	Conclusion	141
4.5	Concluding Remarks.....	142
Chapter 5:	The German Co-Determination Mechanism	144
5.1	A Summary of the Co-Determination System in Germany	144
5.1.1	Co-determination at the Board Level.....	145
5.1.2	The Works Council.....	147
5.2	A Comparison of the Mechanisms in Germany and China.....	148
5.2.1	Employee Representation at the Board Level	149
5.2.2	Employee Representation at the Establishment Level	153
5.2.3	Conclusion	158
5.3	The Ideologies underlying the Chinese and German Employee Participation Mechanisms.....	159
5.3.1	The Ideologies underlying the Workers' Congress in Chinese Firms	159
5.3.2	The Ideologies underlying the German Co-determination Mechanism	162
5.3.3	Compromising Ideologies	165
5.4	Conclusion.....	168
Chapter 6:	The Co-Determination Mechanism in Chinese Takeovers	170
6.1	The Ideology underlying the Suggested Mechanism: from the Perspective of the Model of Corporate Governance	170
6.2	Employee Participation at the Board Level	173

6.2.1	Worker Representation on the BoS and BoD	174
6.2.2	The Establishment of a Chinese Co-determination Mechanism in the Chinese Takeover Context	176
6.2.3	Conclusion	182
6.3	Employee Participation at the Establishment Level	183
6.3.1	Right to be Informed About the Takeover	183
6.3.2	Right to Participate in Takeover Decision-Making	188
6.3.3	Conclusion	191
6.4	The Feasibility of the Suggested Mechanism.....	192
6.4.1	Three Major Challenges that Can Be Addressed	192
6.4.2	Possible Resistance from Chinese Environment	194
6.4.3	Conclusion	197
Conclusion		199
1.	Overview of Research Findings	199
2.	Contributions to Legal Scholarship	203
3.	Limitations: The Complexity and Unstable Chinese Contexts	206
4.	Possible Future Directions: The Reform in a Broader Landscape.....	206
Bibliography		207

Abbreviations and Acronyms

ACFTU	All-China Federation of Trade Unions
BoD	Board of Directors
BoS	Board of Supervisors
CME	Coordinated Market Economy
CPC	Communist Party of China
CSR	Corporate Social Responsibility
CSRC	China Securities Regulatory Commission
HRSS	Ministry or Bureau of Human Resources and Social Security
IPO	Initial Public Offering
LME	Liberal Market Economy
NGO	Non-governmental Organisation
P2P	Peer to Peer
PRC	People's Republic of China
R&D	Research and Development
SASAC	State-owned Assets Supervision and Administration Commission
SOE	State-owned Enterprises
VET	Vocational Education and Training
VoC	Varieties of Capitalism

Introduction

1. Research Background

Hostile Takeovers: The Market for Corporate Control

China is currently experiencing a wave of corporate takeovers; hostile takeovers, being part of it, are thus projected to rise. The term “corporate takeover” refers to “one company acquiring control over another”,¹ while hostile takeovers are those that are opposed by the incumbent management of the target firms.

The first successful hostile takeover was initiated in the UK in 1953, when Charles Clore found that the retailing premises of J. Sears Holding were substantially undervalued.² At the time, the investors’ valuation of a company was largely based on dividends yields, and therefore, the share price of J. Sears was substantially lower than its market value.³ Accordingly, Charles Clore paid a significant premium directly to shareholders of the target firm, a move unwelcome by its management. Despite the management promising to increase the share price to the market value, a majority of shares were sold to the bidder.

Since then, with the development of the stock market, hostile takeovers are deemed as a mechanism to discipline underperforming directors and executives, which is also referred to as “the market for corporate control.”⁴ In large firms, the control over corporate management and policy-making is delegated to the management,⁵ and the objective of the latter is to maximise shareholders’ interests. Any managerial behaviour that deviates from this objective, especially to pursue their own interests,

¹ J. Mukwiri, *Takeover and the European Legal Framework* (Routledge-Cavendish, 2012) 1. The number of domestic mergers and acquisitions rose from 3,176 to 4,999 from 2012 to 2015. See J. Liu, “Analysis of Development Trend of Mergers and Acquisition Market in China 2017” (2017 年中国企业并购市场发展趋势分析) *China Venture Research* (投中研究院), available at <https://www.chinaventure.com.cn/cmsmodel/report/detail/1267.html>.

² J. Franks, C. Mayer, and S. Rossi, “Spending Less Time with the Family: The Decline of Family Ownership in the United Kingdom” in R.K. Morck (ed), *A History of Corporate Governance around the World: Family Business Groups to Professional Managers* (University of Chicago Press- 2005) 581.

³ G. Bull and A. Vice, *Bid for Power* (Elek Books-1958) 30.

⁴ H.G. Manne, “Mergers and the Market for Corporate Control” (1965) 73 *Journal of Political Economy* 110.

⁵ P. McGinty, “Replacing Hostile Takeovers” (1996) 144 *University of Pennsylvania Law Review* 983.

tend to lower the firm efficiency, which is normally accompanied with reductions in share prices. In theory, shareholders have voting rights to replace the management if they deem the latter to be underperforming. However, in practice, this can hardly be achieved for reasons such as shareholders' collective action problems,⁶ especially in large corporations. To make informed voting is costly and shareholders have diverse interests in the company; therefore, the threshold of majority voting can hardly be achieved to replace the management.⁷ Accordingly, it is more convenient and realistic for shareholders of the target firm to "vote with the feet" by selling their shares to acquirers to gain premiums. Under such circumstances, the incumbent management tend to resist the takeover bid to retain their jobs, as a successful takeover normally leads to the replacement of the board and managers.

Employee Vulnerability to Adverse Treatments in the Context of Takeovers

A bidder attempts to recover the premiums they have paid in the hostile takeover through post-takeover operational changes, and one of the most common and effective ways is to cut labour costs.⁸ Accordingly, employees generally experience layoffs, wage reductions, early retirement, or reduction in welfare benefits. Considering the imbalance of power between the employer and employees, the latter is put in a vulnerable position of adverse treatments by the new employer.

This is especially true for China. Since its establishment at the beginning of 1990s, the Chinese securities market has witnessed rapid growth, further evidenced by a proliferation of hostile takeovers in recent years. One of the most high-profile cases in recent years is Baoneng's attempt to obtain control of Vanke,⁹ the largest property development company in China. The bid was unwelcome due to its private ownership

⁶ P. Gourevitch, "Collective Action Problems in Monitoring Managers: The Enron Case as a Systemic Problem" (2002) 3 *Economic Sociology: European Electronic Newsletter* 3.

⁷ W.T. Allen, R. Kraakman, and G. Subramania, *Commentaries and Cases on the Law of Business Organization* (Wolters Kluwer Law & Business-2012) 188.

⁸ S. Bhagat, A. Shleifer, and R.W. Vishny, "Hostile Takeovers in the 1980s: The Return to Corporate Specialization" (1990) *Brookings Papers on Economic Activity: Microeconomics* 1, available at https://scholar.harvard.edu/files/shleifer/files/hostile_takeovers_80s.pdf.

⁹ E.M. Kruszewska, "Target Board's Possible Response to a Hostile Takeover Attempt in China: A Case Study of Vanke vs Baoneng" (2018) 7 *The Academy of Business and Retail Management* 257.

and business backgrounds by the management of Vanke, and accordingly they took measures such as the “White Knight”¹⁰ to frustrate the takeover bid.¹¹ This hostile takeover battle lasted for months and ended up in failure due to the intervention of the party-state. This high-profile hostile takeover battle is only one case in the wave of corporate takeovers in China. Within this context, the conflict between the employer and employees is becoming increasingly intense, which can be noted in the significant amount of news concerning labour conflicts;¹² there were about 138 unlawful labour unrests between 2015 and 2019.¹³ In this context, Chinese workers are in urgent need of a mechanism to safeguard their rights in the context of takeovers.

2. Research Questions and Methodologies

This thesis attempts to address workers’ vulnerability to adverse treatments by augmenting their involvement in the context of hostile takeovers. To achieve this objective, three research questions should be answered step by step in this thesis.

1) *Why should employees’ claims be valued in the context of hostile takeovers?*

This question is answered from three perspectives through theoretical analysis.

First, employees are susceptible to adverse treatments in case of takeovers. To begin with, the new employer tends to seek improvement in the efficiency of the acquired firm, sometimes at the expense of workers’ interests. In addition, the hostile takeover constitutes a breach of implicit contracts between the employer and employees of the target firm, which are sustained by workers’ trust in the

¹⁰ The “White Knight” refers to the takeover defence measure that to seek for a competing friendly acquirer to take the control over the target firm.

¹¹ Financial Times, “Vanke Tussle Points to China’s First Hostile Takeover Battle” (2015) available at <https://www.ft.com/content/f7537254-ad27-11e5-b955-1a1d298b6250>.

¹² One of the most renowned cases of labour conflicts in takeovers is Chinese listed company, O-film, acquiring one of Sony’s subsidiaries in China. Due to the unfair O-film’s treatment of employees, workers went on strikes for two weeks. See: Sina Finance, “The Sale of Subsidiaries in Guangzhou Lead to Labour Unrest and Labour’s Demands for Compensations” (索尼出售其广州工厂遭员工罢工求偿) (2016), available at <http://finance.sina.com.cn/chanjing/2016-11-23/doc-ifyawmm3164167.shtml>.

¹³ China Labor Bulletin, “Strike Map” (2019), available at <https://maps.clb.org.hk/strikes/en>.

management. This breach of workers' trust leads to the expropriation of employees' wealth by shareholders. The third theory arises from the corporate governance model. It is generally agreed that Chinese firms adopt the corporate governance model of shareholder primacy, which prioritises shareholders' interests over those of other stakeholders. In the context of takeovers, this model leads to an inordinate bias towards shareholders' interests even at the cost of other stakeholders, including employees.

Second, taking employee claims into consideration is expected to positively affect a firm's value. The qualitative methodology is used here to argue that employees' deeper involvement in takeover decision making positively affects their productivity and thereby the firm value. In addition, in front of a potential change of ownership, which is characterised by uncertainty and unpredictability, employees tend to withhold their firm-specific investments. A deeper involvement of employees in the process can effectively address this problem. Moreover, adequate employee involvement can play a supervisory role and help curtail management behaviours that are expected to reduce or destroy the maximisation of firm value.

Third, with the development of corporate governance ideologies, challenges to the traditional model of shareholder primacy emerge. Models such as team production theory, enlightened shareholder value, and stakeholder theory are stakeholder-oriented compared to shareholder primacy. All these theories recognise the correlation between the stakeholders' (including employees) interests and a firm's long-term value. These theories provide a theoretical foundation for employee claims to be reasonably considered in the context of hostile takeovers.

- 2) *What are the reasons for labour protection problems in the context of hostile takeovers in China? Why are employees so poorly protected when legislation prescribes various mechanisms for them to express their voice?*

This thesis uses doctrinal and theoretical methodologies to address this question. Two channels have been provided by Chinese law to let workers participate in any takeover process. The first is through employee representatives on the board of directors, and the second is through mechanisms at the establishment level, namely the trade union and the Workers' Congress. However, this thesis finds these mechanisms to be ineffective. By examining the history of these mechanisms, this thesis finds that these institutions were embedded in the old planned economy, which is incompatible with the modern corporate governance structure.

3) *How can the issues of the labour protection be addressed in the context of hostile takeovers in China?*

This thesis attempts to resolve the problems by creating a model where the German co-determination scheme is introduced to Chinese firms in the context of hostile takeovers. The methodologies adopted here are comparative study, doctrinal analysis, and theoretical analysis.

Borrowing rules from one legal system to another is referred to as legal transplants. The literature on this theme has a high level of complexity.¹⁴ Contrary propositions decreases the feasibility of transplanting rules across jurisdictions, especially considering the divergence of cultural and economic environment between the exporting and importing countries.¹⁵ These arguments are reasonable to identify challenges in legal transplantation but cannot constitute the reason to reject its effectiveness in law development or reform in emerging economies, including China. It should be noted that China's long-standing tradition in legal transplanting and most transplanted rules of Chinese corporate and commercial laws are from western countries.¹⁶ However, inspired by these counter arguments, legal

¹⁴ M. Siems, *Comparative Law (Law in Context)* (Cambridge University Press- 2018) 231.

¹⁵ O. Kahn-Freund, "On Uses and Misuses of Comparative Law" (1974) 37 *Modern Law Review* 1.

¹⁶ X. Li, "Thoughts on the Company Law in Old China" (关于旧中国公司法的若干思考) (1997) 7 *Law Science (法学)* 27.

transplants in this thesis should be used in a careful way. Accordingly, three sub-questions should be addressed.

First, why is the German co-determination mechanism chosen as the model for Chinese firms? This thesis explores this question by using the theoretical analysis of the varieties of capitalism approach. Depending on how firms resolve coordination problems central to their competencies, capitalist systems are divided into various types.¹⁷ The German system is referred to as coordinated market economies, which relies on private and insider information rather than the market mechanism to resolve coordination problems. This approach further argues that the incoherence of the market economies tends to negatively affect a country's innovative capabilities as well as the performance of the national economy. By comparing the economic systems between Germany and China, this thesis finds that Chinese firms share a high level of similarities with German firms in terms of coordination with other firms, whereas their ways of coordination with workers are completely different. This leads to an incoherence in the Chinese economic system. This coherence issue needs to be resolved, considering China's urgent demands for economic development and innovation. The most direct and effective way to address this problem is to introduce German ways of treatments on employees, which is mainly represented by the co-determination mechanism. In other words, the introduced German mechanism is coherent with the development direction of Chinese economy, and thus, this is used as the model for Chinese firms.

Second, what are the difference between the laws governing workplace representation and participation in corporate decision-making in China and those in Germany? What are the ideologies underlying the difference of laws in the two countries? These two questions are addressed through comparative study. More specifically, this thesis finds the difference in the corporate organisational structures and a lack of detailed rule to guarantee workers' participation in Chinese firms lead to the ineffectiveness of workers' participation scheme compared to the

¹⁷ P. Hall and D. Soskice, *Varieties of Capitalism: The Institutional Foundation of Comparative Advantage* (Oxford University Press-2001) 8.

German counterparts. This thesis cites path dependence theories¹⁸ to stress the importance of different histories in forming the existing different rules in China and Germany.

Third, how can the German co-determination scheme be adapted to China in the context of hostile takeovers? Since this thesis does not aim to reform the overall corporate structure of Chinese firms, the introduced model should be coherent with existing Chinese corporate laws. In this regard, the thesis finds proper organs as those found in the German system to act as well as make certain amendments to the German rules. It must be admitted that there is resistance to adopting the suggested model, considering the different economic, cultural, and legal backgrounds. However, these problems can be gradually resolved with further implementation of the suggested system.

3. Structure of the Thesis

The chapters of this thesis are arranged as follows. Chapter 1 identifies the signs that predict an increase in hostile takeovers and examines workers' vulnerability to unjust treatment in this context. Chapter 2 lays the theoretical foundations related to the advantages of an enhanced employee protection and participation mechanism. The foundations are two-fold. First, the ideology of shareholder primacy conflict with firms' long-term value and three more stakeholder-oriented corporate governance models, namely enlightened shareholder value, team production theory, and stakeholder theory, are examined. Second, based on economic grounds, greater participation of workers in hostile takeovers is conducive to the interests of firms as well as shareholders. Chapter 3 examines the reasons for the ineffectiveness of the extant Chinese system and provides directions of legal transplantation to resolve these problems. The ineffectiveness of workers' participation mechanisms at the board and establishment levels is examined before the factors leading to such ineffectiveness are explored. At

¹⁸ L.A. Bebchuk and M.J. Roe "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 *Stanford Law Review* 127.

the end of this chapter, the controversy over the method of legal transplants is examined, and a guidance on principles to use this method is provided. Chapter 4 uses the varieties of capitalism approach to argue that the adaptation of the German co-determination system will positively affect the Chinese economy and its innovative capabilities. The varieties of capitalism approach is first introduced before a comparison of the German and Chinese economic systems. At the end of this chapter, the grounds for the adoption of the German system are provided. Chapter 5 identifies the difference in institutional arrangements to let employees participate in hostile takeovers as well as their underlying ideologies. Based on those differences, Chapter 6 makes certain amendments to the German scheme for better adaption into Chinese corporate organisational structure in order to improve workers' information and participation rights in hostile takeovers. Thereafter, factors that may challenge the feasibility of the suggested system are identified and examined respectively.

Chapter 1: The Vulnerability of Employees in Hostile Takeovers

This chapter examines why employee involvement in hostile takeovers is needed. The core reason is that workers are particularly vulnerable to unjust treatment in the context of hostile takeovers. Accordingly, three theories that can explain workers' vulnerability are examined in this chapter. First, since takeovers are considered the market for corporate control, the acquirer has an incentive to improve the firm's efficiency, normally by cutting labour costs. Second, workers rely on their trust in managers with the hope of maintaining a long-term relationship with a firm. However, hostile takeovers breach this trust, and workers lose the returns they expect to accrue from the employment relationship. Third, Chinese firms have adopted the corporate governance model of shareholder primacy, which makes management inappropriately inclined towards the interests of shareholders at the expense of other stakeholders, including employees. This vulnerability has been exacerbating and is a cause for worry, considering that hostile takeovers are projected to rise in China.

The chapter starts with a brief introduction of hostile takeovers in China, which is followed by the predicted increase in hostile takeovers in China. At the end of this chapter, theories that explain workers' vulnerability are analysed.

1.1 Introduction to Hostile Takeovers in China

In order to explore the key arguments of this thesis, it is necessary to briefly introduce its context: the hostile takeovers in China. This section aims to describe how a takeover is made, which mainly focuses on two aspects: 1) the means and procedures of a takeover in China and 2) the target firms' response to the takeover bid if it is hostile.

In general, acquirers have two means to obtain control of a listed company.¹⁹ The first is through voluntary tender offers, when the acquirer make a voluntary offer to all shareholders to purchase partial or all shares of the listed company.²⁰ At the time when the bidder notifies the target firm of its intention to make the tender offer, the bidder should make an indicative announcement of the summary of the report of the offer. After the tender offer is approved by the competent authorities, such as China Securities Regulatory Commission (CSRC), the bidder should make the official public announcement of the tender offer report. The board of directors of the target firm should analyse the conditions of the target company and the tender offer and appoint an independent financial advisor. Within 20 days from the official announcement, the board of directors of the target firm should report whether they recommend shareholders to accept the offer and opinions issued by the financial advisor to the public. The offer period should be between 30 and 60 days. Within 15 days as of the end of the offer period, the bidder should announce the offer result and report it to the stock exchange and CSRC. The second way to purchase shares of the target firms is through agreement.²¹ When the change of interests of the target firm is above 5% or the investor is expected to hold 5% or more interests after the share purchase, it should be reported to CSRC and the stock exchange and be made public.²² If the acquirer holds an interest of more than 30% before the acquisition or is expected to hold more than 30% after the acquisition, the mandatory bid offer rule is triggered.²³

It should be noted that hostile takeovers can hardly be achieved only through a share transfer agreement due to the mandatory bid rule. In order to seize the control of the target firm, the interest that the corporate raider holds after the takeover must exceed the threshold of 30%, which triggers the requirement to use the voluntary tender offer. In addition, the shareholder transfer agreement can only be made when both the target and the acquiring companies are satisfied with the terms and conditions. In other words,

¹⁹ Article 5 of *Measures for the Administration of the Takeover of Listed Companies* (上市公司收购管理办法) (2014) (*Takeover Measures*) and Article 85 of the *Securities Law of People's Republic of China* (中华人民共和国证券法) (2019) (*the Securities Law of PRC*).

²⁰ Article 23-46 of *Takeover Measures* and Article 89-93 of the *Securities Law of PRC*.

²¹ Article 47-55 of *Takeover Measures* and Article 94 of the *Securities Law of PRC*.

²² Article 13 of *Takeover Measures* and Article 85 of the *Securities Law of PRC*.

²³ Article 24 of *Takeover Measures* and Article 96 of the *Securities Law of PRC*.

an agreement can hardly be reached if the board of directors of the target firm resist the potential takeover.

Regarding the approaches of takeover defences, China has adopted a combination of approaches from UK and US,²⁴ which have most developed takeover rules even with the great existing divergence.²⁵ To begin with, in terms of whether shareholders or the board of directors have decisive say over takeover defence tactics, Chinese laws adopt the board neutrality rule, which originates in UK laws.²⁶ According to the board neutrality rule, without the approval of shareholders, directors cannot initiate any action that aims to frustrate the takeover bid.²⁷ However, it should be noted that the Chinese neutrality rule can only be applied when it fulfils the following preconditions:²⁸ 1) the takeover defence measure proposed by the board significantly affects the assets and liabilities of the company, and 2) the defence measures should only be taken after the announcement of the takeover offer. Therefore, the board neutrality rule in Chinese firms leaves room for the board of directors to take defence measures if they can avoid the abovementioned preconditions. In this regard, the board of directors should have a duty of loyalty towards shareholders, which resembles the fiduciary duty in the US laws (Delaware).²⁹ However, Chinese laws only provide general and simple terms of directors' fiduciary duty, and there is no further detail to guide the implementation of this rule. This leaves directors with their own discretion to initiate takeover defence measures if only these measures do not conflict with the Chinese board neutrality rule.

²⁴ J. Armour, J.B. Jacobs, and C.J. Milhaupt, "The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework" (2011) 52 *Harvard International Law Journal* 219.

²⁵ J. Armour and D.A. Skeel, "Who Writes the Rules for Hostile Takeover and Why?—The Peculiar Divergence of US and UK Takeover Regulation" (2006) *Centre for Business Research, University of Cambridge, Working Paper No.331*, available at https://www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp331.pdf.

²⁶ Rule 21 of the *City Code of Takeovers and Mergers* (2018) (*The City Code*).

²⁷ M. Ventrizzo, "Takeover Regulation as a Wolf in Sheep's Clothing: Taking UK Rules to Continental Europe" (2008) 11 *University of Pennsylvania Journal of Business Law* 135.

²⁸ Article 33 of *Takeover Measures*.

²⁹ For example, the fiduciary duty of directors were analysed in cases such as *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d at 955 (Del. 1985), *Moore Corp. Ltd v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545 (D. Del. 1995), *Paramount Commc'ns, Inc., v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994) and *Paramount Commc'ns, Inc. V. Time, Inc.*, 571 A.2d 1140 (Del.1990).

This section sketches out the procedures and the allocation of powers in the target firm in case of hostile takeovers, especially in terms of initiating takeover defence measures. It should be noted that hostile takeovers are perceived as the battlefield where directors of the target firm fight against corporate raiders as well as shareholders of their own firms. However, employees are rarely mentioned by scholars, even though they are vulnerable to adverse treatments in this context. Their vulnerability is becoming increasingly severe and worrisome, especially considering that hostile takeovers are expected to rise in the future. Therefore, in the rest of this chapter, the prediction of a rise in hostile takeovers is made, which is followed by identifying workers' vulnerability in this context.

1.2 The Predicted Rise of Hostile Takeovers in China

This section identifies factors that facilitate the rise and proliferation of hostile takeovers from two aspects. The former is more relevant to the shareholding structures and arrangements, while the latter is related to the Chinese capital market. An increase in hostile takeovers is expected to leave employees worse off, as workers are particularly vulnerable to unjust treatment in this context.

Scholars have carried out productive research anticipating the growing trend of hostile takeovers in China. As pointed out by Demott, "the feasibility of hostile bids in any country depends in large part (1) on shareholders' ability to transfer their shares freely, (2) on the pattern of share ownership of that country, and (3) on the voting rights allocated to publicly-held shares".³⁰ It should be noted that Chinese listed firms are compatible with all three factors.

In response to the former two factors,³¹ scholars have identified two signs that would promote the increase of hostile takeovers in China. The first is attributed to the equity

³⁰ D.A. Demott, "Comparative Dimension of Takeovers" (1987) 65 *Washington University Law Quarterly* 69.

³¹ In terms of the third factor "the voting rights allocated to publicly-held shares", Chinese laws currently forbid the dual class stock structure, which means the acquirer is able to gain the control of the target company once it purchases enough shares. However, it should be noted that the state has expressed their intentions to experiment with the dual class stock structure recently. See the State Council of People's Republic of China (PRC), *The Opinions on Promoting the High-Quality Development of Innovation and Entrepreneurship to Upgrade the Innovation-*

division reform,³² which made previously non-tradable equities of listed companies tradable. Non-tradable equities are a legacy of the planned Chinese economy. At that time, almost two-thirds of shares could not be sold on the securities market.³³ Non-tradable equities were caused by the party-state's uncertainty on whether certain type of equities, such as state-owned and enterprise-owned equities, should be traded on Chinese stock exchanges at the establishment of the Chinese securities market. This can be attributed to the predicament of state-owned enterprises and some other types of enterprises such as township and village enterprises, who had "lots of problems such as financial distress, overstaff, heavy burden, and so on".³⁴ Considering that these non-tradable shares were normally held by the controlling shareholder, if these shares could be traded, share prices were expected to drop significantly, and the party-state might suddenly lose control of state-owned enterprises. The existence of non-tradable shares was perceived as an obstacle for hostile takeovers, since the volume of tradable shares on the market was insufficient for the acquirer to gain control of the target firm. Accordingly, the acquirer was required to purchase non-tradable shares by private agreement rather than tender offers, which was difficult to achieve, given the likelihood of the incumbent management rejecting any such offer.³⁵ In line with the theory of Demott, the equity division reform eliminated the difference between tradable and non-tradable shares, and accordingly made available more shares on the capital market. Shareholders will then be able to transfer shares freely.

The greater circulation of shares is able to disperse the hitherto concentrated ownership of Chinese companies,³⁶ which is the second sign that is perceived as enabling the rise of hostile takeovers. Concentrated ownership structures are deemed to hinder hostile

Entrepreneurship Initiative (国务院关于推动创新创业高质量发展打造双创升级版的意见) (2018).

³² This reform was started by the promulgation of China Securities Regulatory Commission, *Regulatory Measures on the Equity Division Reform of Listed Companies* (上市公司股权分置改革管理办法) (2005).

³³ Z. Yang, "The Impact of Equity Division Reform on Investors" (2017) *International Conference on Economics, Management Engineering and Marketing (EMEM 2017)* 42.

³⁴ H. Zhang and Z. Wang, "The Study of Equity Division Reform Effect on Chinese Listed Companies Financing Behaviors" (2009) *2009 International Conference on Management and Service Science* 1, available at <https://ieeexplore.ieee.org/document/5303567>.

³⁵ H. Huang, "The New Takeover Regulation in China: Evolution and Enhancement" (2008) 42 *The International Lawyer* 153.

³⁶ This is because non-tradable shares were normally held by the controlling shareholder, and since more shares are allowed to be traded freely, this will encourage Chinese companies to form more scattered ownership structures.

takeovers, because a transfer of control can only be achieved with the voluntary permission of the controlling shareholders of target firms. On the other hand, a lower degree of ownership concentration can promote the liquidity of the market in China, thereby facilitating takeovers, especially hostile takeovers.³⁷ Some researchers have argued that concentrated ownership structures in the private sector arise from the ineffective investor protection mechanisms in China.³⁸ Accordingly, shareholders tend to use concentrated ownership as an alternative to external legal protection.³⁹ However, with the maturing of the Chinese legal system, controlling shareholders are now more willing to disperse ownership. There are also scholars who project more dispersed ownership structures of private companies due to the frequent use of stock options to tie key employees to companies, and founders handing over control to their children, where the latter emphasize the important role of professional management and the capital markets.⁴⁰ In addition, scattered ownership structures are normally accompanied by a market-centred economy, where hostile takeovers flourish. This is compatible with the objective of the reform of the Chinese securities market.⁴¹ As John Coffee states, dispersed ownership structures are “characterized by strong securities markets, rigorous disclosure standards, and high market transparency, in which the market for corporate control constitutes the ultimate disciplinary mechanism” and “the hostile takeover, its final guillotine”.⁴² Admittedly, although shareholding structures are becoming dispersed, they still remain relatively concentrated, especially compared to companies in the United States. As a result, hostile takeovers have hitherto rarely been seen in the Chinese stock market.⁴³ However, it should be noted that the

³⁷ R. La Porta, F. Lopes-de-Silanes, and A. Shleifer, “Corporate Ownership around the World” (1999) 54 *The Journal of Finance* 471.

³⁸ H. Deng, “Constraining the Majority Shareholders under the Concentrated Ownership Structures of Chinese Listed Firms” (我国上市公司股权集中模式下的股权制衡问题) (2008) 6 *China Legal Science (中国法学)* 145.

³⁹ R. La Porta, F. Lopes-de-Silanes, A. Shleifer, and R.W. Vishny, “Legal Determinants of External” (1997) 52 *The Journal of Finance* 1131.

⁴⁰ L. Zhang, “The Potential Rise of Hostile Takeovers in China: Efficiency, Politics and Law” (2014) 12 *China: An International Journal* 136.

⁴¹ See an interview of the press spokesperson of China Securities Regulatory Commission, D. Chang, see Sina Finance, “China Securities Regulatory Commission: To Promote the Reform of the Market for Mergers and Acquisitions” (证监会: 积极推动并购重组市场化改革) (2018), available at <http://finance.sina.com.cn/china/qncj/2018-08-18/doc-ihhvcix0254130.shtml>.

⁴² J.C. Coffee, “The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control” (2001) 111 *Yale Law Journal* 1.

⁴³ R.H. Huang and J. Chen, “Takeover Regulation in China: Striking a Balance between Takeover Contestability and Shareholder Protection” in U. Varottil and W.Y. Wan (eds), *Comparative Takeover Regulation: Global and Asian Perspectives* (Cambridge University Press-2018) 211.

shareholding structures of Chinese firms are now visibly becoming dispersed, as reflected in the statistics.⁴⁴ From this perspective, it can be reasonably expected that hostile takeovers will rise in the future, having already started with the first successful hostile takeover reported by the media.⁴⁵

The third factor, namely the voting rights allocated to shares in public-held companies, does not constitute an obstacle for takeovers in China. This factor relates to the issue of separate classes of stock that hold different voting rights. In particular, shares available for sale should be accompanied by sufficient voting rights to allow the acquirer to take control of the firm. However, although the Chinese government is considering allowing the emergence of dual class equity structure in Chinese firms,⁴⁶ the principle of one-share-one-vote is largely upheld by Chinese firms, so that voting rights are not really an obstacle for the prevalence of hostile takeovers.

In addition to the three abovementioned factors, scholars attribute macroeconomic factors that make takeovers attractive to the rise of hostile takeovers.⁴⁷ The first is the decreasing intervention of the state in the capital market, which is perceived as an impediment to hostile takeovers. This opinion is relevant even in the private sector, considering that the government, through the CSRC, has the authority to approve takeovers. However, the responsibility of CSRC is restricted to overseeing the legitimacy of a takeover. In general, CSRC has remained silent in the wake of hostile takeover attempts, which complies with its long-standing objective of developing a market-oriented Chinese stock exchange. Therefore, the party-state cannot be perceived as an obstacle in the rise of hostile takeovers, at least in the private sector.

⁴⁴ According to the statistics collected by China Stock Market & Accounting Research Database (CSMAR Solution) available at <http://www.gtarsc.com>, by Sep 30, 2014, the listed company with the largest shareholder holding 50% or more shares accounted for 19.84% of all (512/2580), in comparison with 21.76% (386/1774) by Dec 31, 2009 and 35.08% (483/1377) by Dec 31, 2004. As to the largest shareholder holding 30% or more shares, the ratio was 58.37% (1506/2580) by Sep 30, 2014, 59.19% (1050/1774) and 65.36% (900/1377).

⁴⁵ Y. Wang, "Analysing the First Successful Marketized Hostile Takeover in A-Share" (解码 A 股首例成功市场化敌意并购案) (2018) *JRJ.com*, available at <http://stock.jrj.com.cn/2018/06/29033024743240.shtml>.

⁴⁶ *Xinhua News*, "China Securities Regulatory Commission Suggests Separate Class of Stock Structure" (03 Sep 2018), available at http://www.xinhuanet.com/fortune/2018-09/03/c_129945588.htm.

⁴⁷ Armour et al (n 7).

The second is the increased attractiveness of the target firms in the market due to attractively priced shares of listed firms. This can be evidenced by the Shanghai composite index, which dropped from more than 5000 in mid-2015 to around 3000 at the end of 2019.⁴⁸ For instance, the market value of China First Heavy Industries, the manufacturing giant in China, declined by 84% during this period.⁴⁹ Under this context, more listed firms are vulnerable to takeovers, as shares of these firms are cheaper and more attractive to corporate raiders.

The third factor is that the obstacles to acquirers' funding have been removed.⁵⁰ In the early stages of the development of the Chinese capital market, firms were prohibited from taking loans from commercial banks to make equity investments.⁵¹ However, this prohibition was lifted in 2008, when China Banking Regulatory Commission permitted commercial banks to provide funding for firms to acquire other firms.⁵² In 2015, corporate acquirers got more channels for funding when peer-to-peer (P2P) lending (one form of internet finance) and lending between firms became permissible.⁵³ Thus, acquirers are now more likely to have adequate funds to acquire attractive target firms.

To sum up, three factors contribute to the increase in hostile takeovers in China in the future. First, with the development of Chinese capital market, the shareholding structure is becoming more dispersed and shares can easily be traded. Second, the party-state has reduced its intervention in the takeover market. Accordingly, corporate acquirers are legally permitted to raise funds from more sources, while the party-state tends not to reject hostile takeovers if only the procedures do not violate existing rules. Third, the Chinese stock market is becoming more attractive for hostile takeovers, especially considering the general declining share prices of listed firms. In this context,

⁴⁸ Shanghai Stock Exchange, statistics available at <http://www.sse.com.cn/market/sseindex/overview/focus/>.

⁴⁹ Statistics from Investing.com, available at <https://cn.investing.com/equities/cn-first-heavy-historical-data>.

⁵⁰ R.H. Huang and J. Chen, "The Rise of Hostile Takeovers and Defensive Measures in China: Comparative and Empirical Perspectives" (2019) 20 *European Business Organization Law Review* 363.

⁵¹ Article 20 of *General Rules of Lending* (《贷款通则》) (1996).

⁵² Article 1 of *Guidelines on the Risk Management of M&A Loans of Commercial Banks* (《商业银行并购贷款风险指引》) (2008).

⁵³ Articles 11 and 22 of *Provisions of the People's Supreme Court on Several Issues concerning the Application of the Law in Private Lending Cases* (《最高人民法院关于审理民间借贷案件适用法律若干问题的规定》) (2015).

more hostile takeovers are expected to put employees in unfavourable positions, where they are vulnerable to unjust treatment, and this is examined in the next section.

1.3 The Vulnerability of Employees in Hostile Takeovers

This section examines the necessity of employee protection in the face of an increase in hostile takeovers, wherein employees are particularly vulnerable to unjust treatment in this context. The most direct reason is that restructuring of the target firm has been widely witnessed to accompany takeovers, especially hostile takeovers, and hence workers are more likely to be exposed to risks including changed working conditions, increased work intensity, job transfer, and/or mass redundancies.⁵⁴

The vulnerability of employees in hostile takeovers has attracted a broad range of academic interest, which in general covers three aspects. First, going by the theory of “the market for corporate control”, takeovers lead to a reallocation of resources that aims to improve the efficiency of the target firms, and therefore labour costs are likely to be reduced. Second, takeovers lead to a transfer of wealth from employees to shareholders, which constitutes a breach of the implicit contract between the employer and employees. Third, the corporate governance model of shareholder primacy adopted by Chinese laws promotes an inordinate inclination among Chinese firms towards the interests of shareholders, leading to employees’ interests receiving less consideration in the context of hostile takeovers. All three aspects are examined in the remaining sections of this chapter.

1.3.1 Incentives to Improve the Efficiency of Target Companies

The first manifestation of employees’ vulnerability is that new controllers may seek to improve the efficiency of acquired companies at the expense of the employees’ interests. This is inspired by “the market for corporate control”, where hostile takeovers are perceived as a mechanism to discipline incompetent management of

⁵⁴ J. Cremers and S. Vitols, *Takeovers with or without Worker Voice: Workers’ Rights under the EU Takeover Bids Directive* (European Trade Union Institute-2016) 11.

target companies. In summary, the poor management of companies leads to a fall in share prices, which in turn encourages takeover attempts. As a result, the threat of hostile takeovers stimulates management's incentive to raise the firm value for fear of losing their jobs, because incompetent incumbent management are normally removed after hostile takeovers.

This theory is based on two assumptions; the first is that target firms are poorly managed before hostile takeovers. The criteria based on which the firm's management can be assessed comes from the agency theory. As defined by Jensen and Meckling, "an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent(s)) to perform some service on their behalf which involves delegating some decision-making authority to the agent."⁵⁵ Shareholders and management constitute the agency relationship, which originates from the separation of management from ownership in modern companies. As highlighted by Berle and Means, shareholders who own large companies do not manage it whilst those who have control over the firm do not necessarily have substantial ownership interests.⁵⁶ Three grounds have been found to explain this separation. First, in large corporations that feature dispersed ownership, shareholders are expected to be rationally apathetic to exercise their voting rights, because "each individual shareholder has only a small interest in any given firm"⁵⁷ and they reasonably assume that their voting cannot make any real influence on the result. Accordingly, it is necessary to delegate the management control to directors. Second, in the modern economy, a company should respond quickly to the market change by taking wise and decisive measures to improve competencies of firms. Accordingly, it becomes necessary to hire professional managers, who expertise in business and managerial skills. By engaging in day-to-day management and operations of the firm, professional managers gain the informational advantage over shareholders, making the latter further incapable to retain the firm control. Third, with the development of the securities market, shares of large corporations can be transferred more freely. Accordingly, some shareholders tend to

⁵⁵ M. C. Jensen and W. H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305 at 308.

⁵⁶ A.A. Berle and G.G.C. Means, *The Modern Corporation and Private Property* (Transaction Publishers-1991) 181.

⁵⁷ J. Velasco, "Taking Shareholder Rights Seriously" (2007) 41 *U.C. Davis Law Review* 605 at 622.

focus on short-term gains rather than the firms' long-term value because they can easily sell their shares and quit the company.⁵⁸ In contrast, managers' reputation binds closely with the firm's performance, because it will determine their salaries at the next stage of their career. In this case, control of managers rather than shareholders is compatible with the interest of the firm.

To sum up, the separation of management from ownership increases company benefits. This can explain the motivation for shareholders, who act as principals, to hire managers for their interests. This is because shareholders are perceived as "residual interest holders" in the company, which means that "if the company ceased trading, they would have a claim to all the company's assets once all creditors have been repaid."⁵⁹ Therefore, to increase the firm value aligns with shareholders' interests, and any managerial behaviours that are not in the best interest of shareholders incur agency costs.

Based on the belief that people are self-interest-driven and rational,⁶⁰ interests of the management do not always align with those of shareholders. In order to limit divergences from the interests of shareholders, agency costs are incurred, which can be divided into three categories.⁶¹ First, shareholders are supposed to bear the expenditures of monitoring the behaviour of the management, referred to as "monitoring costs". Second, managers are allowed by shareholders to expend resources to guarantee that the management acts in the best of shareholders; if managers do not, they are allowed to recover such cost. This is known as "bonding costs". Third, even after monitoring and bonding activities, costs may arise due to managers' non-aligned interests with shareholders, and this is referred to as "residual loss". In addition, by realising that people may not always act in their own interests, scholars identified other sources of agency costs, such as managers' incompetency. Inspired by the economic theory of self-control problems,⁶² scholars find that

⁵⁸ J. C. Stein, "Takeover Threats and Managerial Myopia" (1988) 96 *Journal of Political Economy* 61.

⁵⁹ D. Kershaw, *Company Law in Context: Text and Materials* (Oxford University Press-2012) 175.

⁶⁰ This belief can be traced back to Adam Smith. See: A. Smith, *The Wealth of Nations* (University of Chicago Press-2012) 460.

⁶¹ Jensen & Meckling (n 55) at 308.

⁶² R.H. Thaler and H.M. Shefrin, "An Economic Theory of Self-Control" (1981) 89 *The Journal of Political Economy* 392. This theory perceives individuals as an organization to explain why some individuals may take actions that

managers may take actions that are harmful to them as well as shareholders.⁶³ Therefore, limiting agency costs is one of the primary objectives of corporate governance. Firms with high agency costs normally accompany poor performance. For instance, in order to entrench their position, managers tend to offer above-market wages or long-term contracts to employees.⁶⁴ These firms are more attractive for corporate raiders and are more likely to be exposed to the threat of hostile takeovers.⁶⁵

Accordingly, this leads to the second assumption of this theory, which is that a transfer of control in takeovers leads to a reallocation of resources and management turnover,⁶⁶ thereby mitigating agency costs as well as enhancing the firm performance. In order to improve the profitability of acquired firms, the new management adopt measures such as “downsizing or relocating operations, which in many cases causes collective employee layoffs”.⁶⁷

It should be noted that the academic literature has diverse views on “the market for corporate control”. With regard to the first assumption of this theory, there are scholars who have provided evidence that target companies are managed below the average level prior to takeovers.⁶⁸ However, counter arguments show that there is little evidence of the poor performance of target companies prior to takeovers.⁶⁹ Takeovers, therefore, may or may not perform a disciplinary function, as suggested by “the market for corporate control” approach. Similarly, when it comes to the second assumption, there is no agreement on the impact of takeovers on acquired companies. Some studies support the positive impact of takeovers on firm performance,⁷⁰ which is inconsistent

are against their own interests.

⁶³ M.C. Jensen, “Self-interest, Altruism, Incentives, and the Agency Theory” (1994) 7 *Journal of Applied Corporate Finance* 40.

⁶⁴ M. Pagano and P.F. Volpin, “Managers, Workers, and Corporate Control” (2005) 60 *The Journal of Finance* 841.

⁶⁵ It should be noted that acquirers may have different attitudes towards the strategy taken by incumbent management. For instance, in some takeover cases, such high employment costs may be used as a strategy to drive takeover raiders away.

⁶⁶ M. Pargendler, “Takeovers, Ownership Structures, and Control Premiums: A Comparative Analysis” 2 *Cadernos do Programa de Pós-Graduação em Direito—PPGDir.UFRGS* 377.

⁶⁷ K. Coucke, E. Pennings, and L. Sleuwaegen, “Employee Layoff under Different Modes of Restructuring: Exit, Downsizing or Relocation” (2007) 16 *Industrial and Corporate Change* 161.

⁶⁸ G.F. Davis and S.K. Stout, “Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Targets, 1980-1990” (1992) 37 *Administrative Science Quarterly* 605.

⁶⁹ J. Frank and C. Mayer, “Hostile Takeovers and the Correction of Managerial Failure” (1996) 40 *Journal of Financial Economics* 163.

⁷⁰ M.S. Schranz, “Takeovers Improve Firm Performance: Evidence from Banking Industry” (1993) 101 *Journal of*

with observations made by other scholars, who have argued that takeovers do not affect firm performance, in the US⁷¹ and the UK.⁷²

This divergence in academic views is reasonable, since studies on “the market for corporate control” are challenging. This is because the result of the research is sensitive to the definition of performance, methodology selected, country selected, time period, or benchmarks constructed.⁷³ The valuation of target firms is central to this theory. However, due to the myopia of the market and volatility of share prices, the valuation of the target management may fail to reflect how target firms are managed,⁷⁴ making research that tests the validity of this theory very difficult. Even in conditions where new controllers are willing to pursue better performance by the target firms, the acquired firms may not perform as well as expected, due to a failure of management or “hubris” of the new controller leading to their overestimation of their ability to enhance firm performance.⁷⁵ As a result, the feasibility of this theory can hardly be assessed and proved, which leads to the dissonance witnessed in the conclusions of the empirical studies.

“The market for corporate control” explains acquired companies’ incentives to improve efficiency and the corresponding negative treatment of employees. However, this is not feasible in all types of takeovers. There are various motives for takeovers, some of which may not aim at a reduction of agency costs or an improvement in the performance of target firms. For instance, acquirers are likely to use takeovers to achieve economies of scale, to add complementary resources to the combined firm for synergy gains, to save taxes, to achieve monopolies, or to buy “entry” into a new business or market.⁷⁶ Some of these motives do not focus on improving efficiency of

Political Economy 299.

⁷¹ S. Dutta and V. Jog, “The Long-term Performance of Acquiring Firms: A Re-examination of an Anomaly” (2009) 33 *Journal of Banking & Finance* 1400.

⁷² A.P. Dickerson, H.D. Gibson, and E. Tsakalotos, “The Impact of Acquisitions on Company Performance: Evidence from a Large Panel of UK Firms” (1997) 49 *Oxford Economic Papers* 344.

⁷³ D. Wang and H. Moini, “Performance Assessment of Mergers and Acquisitions: Evidence from Denmark” (2012) *E-Leader Berlin* 1 available at <http://www.g-casa.com/conferences/berlin/ppt/Wang.pdf>.

⁷⁴ M. Höpner and G. Jackson, “An Emerging Market for Corporate Control? The Mannesmann Takeover and German Corporate Governance” (2001) (01/4) *MPIfG Discussion Paper* 1.

⁷⁵ R. Roll, “The Hubris Hypothesis of Corporate Takeovers” (1986) 59 *The Journal of Business* 197.

⁷⁶ A. Pendleton, “The Employment Effects of Takeovers” in J. Cremers and S. Vitols (eds), *Takeovers with or without Worker Voice: Workers’ Rights under the EU Takeover Bids Directive* (European Trade Union Institute-2016) 71.

the acquired companies, and therefore cannot be explained by “the market for corporate control”. That is to say, a reduction of labour costs can only be witnessed in certain types of takeovers. To be specific, mass redundancies and a decrease in wages are normally observed in takeovers with the objective of a reduction of overcapacities, or accompanied by post-takeover restructuring measures, such as downsizing overlapping activities, including the removal of production facilities and head office administration.⁷⁷

In conclusion, according to the theory of “the market for corporate control”, workers are vulnerable to unjust treatment after takeovers because new management often have an incentive to improve the performance of the acquired firms. However, these incentives can be hardly assessed or proved. In addition, it should be noted that this explanation for workers’ vulnerability is only plausible in certain types of takeovers, because not all corporate raiders have an incentive to enhance the target firm’s efficiency after the acquisition. Therefore, this thesis moves on to examine the second explanation for workers’ vulnerability, which is that hostile takeovers will lead to a breach of the implicit contracts between employees and shareholders.

1.3.2 A Breach of Trust in Hostile Takeovers

An Introduction to the Theory of Implicit Contracts

This theory was first put forward by Shleifer and Summers,⁷⁸ who held that takeovers would bring about wealth redistribution and shareholders’ expropriation of rents⁷⁹ from employees. This leads to a breach of implicit contracts between employees and the company, which are sustained by a management’s reputation for trustworthiness.

⁷⁷ E. Lehto and P. Bockerman, “Analysing the Employment Effects of Mergers and Acquisitions” (2008) 68 *Journal of Economic Behavior & Organization* 112.

⁷⁸ A. Shleifer and L.H. Summers, “Breach of Trust in Hostile Takeovers”, in A.J. Auerbach (ed), *Corporate Takeovers: Causes and Consequences* (University of Chicago Press-1988) 33.

⁷⁹ In the view of economists, rents refer to the return to any factor of production in excess of its supply costs. Accordingly, shareholders’ rents refer to the return to their shareholding ownership in excess of their capital investment.

In order to explore this theory, this section starts by introducing the theory of implicit contracts.

Implicit contracts arise from the nexus-of-contract theory, which perceives a company as “a legal fiction which serves as a nexus for a set of contracting relationships among individuals”.⁸⁰ Accordingly, the relationship between the company and employees is established through explicit and implicit contracts. Implicit contracts include conditions and arrangements that cannot be specified in explicit contracts. In particular, due to the complexity of employees’ relationship with shareholders,⁸¹ parties cannot fully anticipate everything in explicit contracting ex ante. As to circumstances that can be predicted, it will be too costly to include everything in explicit contracts. In addition, some conditions that relate closely to workers’ interests, such as decisions on takeovers, cannot be contracted, because this business operation should be at the discretion of management,⁸² i.e. implicit contracts can “help circumvent difficulties in explicit contracting”.⁸³

According to the theory of implicit contracts, employees and the company tend to develop a long-term relationship. There are mainly three reasons for this inclination. The first reason concerns employees’ risk aversion. Employees need job security to avoid negative consequences of involuntary unemployment, such as a loss of income for a certain period. As they grow older, this need becomes more urgent, because their opportunities for re-employment are expected to decrease.⁸⁴ The aging problem is especially pressing for workers engaged in labour-intensive activities, whose productivity is expected to decrease as they get older. As a consequence, they have fewer opportunities for re-employment.⁸⁵ Unlike shareholders, who tend to hold equity

⁸⁰ Jensen and Meckling (n 55) at 310.

⁸¹ S. J. Grossman and O. R. Hart, “The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration” (1986) 94 *Journal of Political Economy* 691.

⁸² C.B. Craver, “The Impact of Financial Crises upon Collective Bargaining Relationships” (1987) 56 *George Washington Law Review* 465.

⁸³ G. Baker, R. Gibbons, K.J. Murphy, “Implicit Contracts and the Theory of the Firm” (1997) *NBER Working Paper No. 6177* available at <https://www.nber.org/papers/w6177.pdf>.

⁸⁴ L. Funk, “Employment Opportunities for Older Workers: A Comparison of Selected OECD Countries” (2014) 2 *CEifo DICE Report* 22.

⁸⁵ J.R. Macey, “Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes” (1989) 38 *Duke Law Journal* 173.

in different companies, employees normally have one job, and therefore cannot diversify their risks.⁸⁶ Accordingly, employees' demand for a long-term employment relationship is urgent. In return for treating employees fairly and ethically, the company is expected to secure advantages in attracting, retaining, and motivating more qualified employees.⁸⁷ This good reputation of decent human resource management practice is also positively related to the firm value, as shown by empirical studies.⁸⁸

The second reason arises from the "firm-specific human capital hypothesis". The term "human capital" refers to the knowledge and skills that can only be acquired when some investments of time and resources are made.⁸⁹ These investments are shared by employees and the employer,⁹⁰ engendering the need for both parties to have a long-term relationship. To be specific, when employees are given job security, they are more willing to devote themselves to developing firm-specific skills, which is perceived to improve the productivity and innovation of the firm.⁹¹ These skills may lose their value when employees change their job, which is evidenced by a decrease in earnings on their next job.⁹² Meantime, employees who show a propensity for long-term employment are more likely to receive investments by the company in training and education.⁹³ These workers may help the company gain a competitive advantage against its rivals. Accordingly, the employer tends to bind employees with specialized skills by offering higher wages and better welfare.

The third reason is related to the second and considers the costs of layoffs. For the employer, a loss of employees with specialized skills leads to a waste of capital

⁸⁶ M.A. O'Connor, "Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers" (1992) 69 *North Carolina Law Review* 1189.

⁸⁷ H.S. Albinger and S.J. Freeman, "Corporate Social Performance and Attractiveness as an Employer to Different Job Seeking Populations" (2000) 28 *Journal of Business Ethics* 243.

⁸⁸ K.W. Chauvin and J.P. Guthrie, "Labor Market Reputation and the Value of the Firm" (1994) 15 *Managerial and Decision Economics* 543.

⁸⁹ G.S. Becker, *Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education* (University of Chicago Press-1994) 15.

⁹⁰ M. Hashimoto, "Firm-Specific Human Capital as a Shared Investment" (1981) 71 *The American Economic Review* 475.

⁹¹ M. Aoki, *The Co-operative Game Theory of the Firm* (Clarendon Press-1984); V. Acharya, R. Baghai-Wadji, and K. Subramanian, "Wrongful Discharge Laws and Innovation", *NBER Working Paper No. 18516*, available at <http://www.nber.org/papers/w18516>.

⁹² L.S. Jacobson, R.J. Lalonde and D.G. Sullivan, "Earnings Losses of Displaced Workers" (1993) 83 *The American Economic Review* 685.

⁹³ M.M. Blair and M.J. Roe, *Employees and Corporate Governance* (Brookings Institution Press-1999) 61.

expenditure, because no further rewards can be collected from the investments in training and education. Likewise, employees who have dedicated themselves to developing firm-specific skills are unable to collect further returns when they leave the firm, also leading to a loss of capital.⁹⁴ In addition, arising from their desire for long-term employment and their trust in the employer, employees tend to accept wages that are below the market level, in the hope of being overpaid in subsequent periods.⁹⁵ Therefore, involuntary unemployment will raise employees' opportunistic costs, arising from a loss of higher income.

In summary, both the employer and employees have a strong motivation to stabilize the employment relationship. However, the employer, rather than employees, is normally the party who fails to adhere to implicit contracts. This is because managers are comparatively sophisticated and have informational advantages, and they are more able to cope with risks arising from a breach of implicit contracts. Since there is no legal system for enforcement, employees can only emotionally depend on managers' credibility to realise their promises, such as to retain long-term employment and to increase workers' income in the future. However, this emotional trust is vulnerable to a breach in the context of takeovers.

A Breach of Trust in Hostile Takeovers

A breach of trust is normally accompanied by the replacement of the firm's managers. In order to retain their reputation of trustworthiness, incumbent management are committed to upholding employees' claims. This trust "develops over time based on the historical experience that employees and management have with each other".⁹⁶ As a result, incumbent management tend to safeguard workers' interests in takeovers, sometimes even against shareholders' interests. The reason for managements' alliance with employees may also be attributed to managers' pursuance of private interests. For managers who have a small equity stake, in order to entrench their positions and

⁹⁴ Becker, *Human Capital* (n 88) 21.

⁹⁵ R. Hutchens, "Delayed Payment Contracts and a Firm's Propensity to Hire Older Workers" (1986) 4 *Journal of Labor Economics* 439.

⁹⁶ L. Barger, K. Lehn, and J. Smith, "Employee-Management Trust and M&A Activity" (2015) 35 *Journal of Corporate Finance* 389.

maximize the benefits of control,⁹⁷ they may offer long-term employment contracts to employees (as “shark repellents”), thereby reducing the attractiveness of the firm as a target.⁹⁸ In addition to placing obstacles for corporate raiders, this takeover defence measure is expected to reduce the profitability of target firms,⁹⁹ which harms the interests of shareholders in target firms. After completion of the takeover, prior management are also deemed to hinder firm profitability, since the returns of firms that choose to retain prior management tend to be lower than those that changed managers.¹⁰⁰ As a result, prior management may conflict with the interests of shareholders in target and acquired firms, and therefore a change of management is normally witnessed in takeovers. Employees’ trust in prior management is attributable to their historical experience, which is not shared with the new management. Accordingly, the new management do not share the same level of employees’ trust.

The motivation for new managers to renege on implicit contracts with employees is to increase the shareholders’ value, which is mainly through an expropriation of employees’ rents.¹⁰¹ To be specific, workers acquiring firm-specific knowledge is critical for the generation of economic rents.¹⁰² If workers are not sufficiently rewarded for their investments of time and effort by shareholders, their rents are deemed to be expropriated. Although scholars have identified value creation effects in takeovers, there are also at least partial shareholder gains at the expense of employees’ interests,¹⁰³ leading to a breach of implicit contracts.

⁹⁷ F. Ippolito, “Takeover Defenses, Firm-specific Skills and Managerial Entrenchment” (2010), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1018716.

⁹⁸ M. Pagano and P.F. Volpin, “Managers, Workers and Corporate Control” (2005) 60 *The Journal of Finance* 841.

⁹⁹ P.A. Gompers, J.L. Ishii, and A. Metrick, “Corporate Governance and Equity Prices” (2003) 118 *Quarterly Journal of Economics* 107.

¹⁰⁰ J.D. Parrino and R.S. Harris, “Takeovers, Management Replacement, and Post-Acquisition Operating Performance: Some Evidence from the 1980s” (1999) 11 *Journal of Applied Corporate Finance* 88.

¹⁰¹ M. Schnitzer, “‘Breach of Trust’ in Takeovers and the Optimal Corporate Charter” (1995) 43 *The Journal of Industrial Economics* 229. The definition of rents is given in (n 79). In this context, employees’ rents refer to the return to the labour over the costs of their supply to the employer.

¹⁰² H. Wang, J. Choi, G. Wan, and J.Q. Dong, “Slack Resources and the Rent-Generating Potential of Firm Specific Knowledge” (2016) 42 *Journal of Management* 500.

¹⁰³ A. Kuvandikov, A. Pendleton, and D. Higgins, “Shareholders, Managers, and Employees: Rent Transfer or Rent Sharing in Corporate Takeovers” (2014), available at <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.638.9460&rep=rep1&type=pdf>.

This thesis provides two examples of new controllers' measures of restructuring firms in the immediate aftermath of takeovers, which are deemed to violate workers trust. First, the level of training and education of employees is not taken cognisance of by the market or by the future employers.¹⁰⁴ Therefore, workers who have made significant firm-specific investments may not be appreciated and valued by new managers. They tend to sack senior employees with wages exceeding their marginal productivity, who may have been underpaid at the early stage of their career.¹⁰⁵ Instead, new employees who settle for lower wages may be hired to reduce the costs in corporate management. Second, acquired companies may close plants with the objective of improving the firm's profitability, leading to massive layoffs or job transfers.¹⁰⁶ It is challenging for workers who lose their jobs to find equivalent and satisfactory alternative employment.¹⁰⁷ Those who are transferred may be forced to accept another job for which they are less qualified due to a lower level of acquired training and education. It should be noted that there are some employees who are reluctant to accept their new job positions, possibly due to an unwillingness to move to other areas where the new plants are located.¹⁰⁸ Thereafter, they may choose to terminate their employment voluntarily.

Conclusion

The theory of implicit contracts is founded on a trust-based framework. Based on trust in incumbent management, workers prefer a long-term relationship, and are accordingly willing to invest their time and effort in developing their firm-specific skills. This in turn is compatible with the employer's incentive to enhance efficiency and retain their reputation of trustworthiness. However, in hostile takeovers when managers are normally replaced, a breach of implicit contracts is witnessed, in the form

¹⁰⁴ E. Katz and A. Ziderman, "Investment in General Training: The Role of Information and Labour Mobility" (1990) 100 *The Economic Journal* 1147.

¹⁰⁵ D. Neumark and S.A. Sharpe, "Rents and Quasi Rents in the Wage Structure: Evidence from Hostile Takeovers" (1996) 35 *Journal of Economy and Society* 145.

¹⁰⁶ D.W. Blackwell, M.W. Marr, and M.F. Spivey, "Plant-Closing Decisions and the Market Value of the Firm" (1990) 26 *Journal of Financial Economics* 277.

¹⁰⁷ C.R. Leana and D.C. Feldman, "Finding New Jobs after a Plant Closing: Antecedents and Outcomes of the Occurrence and Quality of Reemployment" (1995) 48 *Human Relations* 1381.

¹⁰⁸ D.E. Herz, "Worker Displacement in a Period of Rapid Job Expansion: 1983-87" (1990) 113 *Monthly Labor Review* 21.

of job losses and wage cuts, since new controllers are not bound by similar reputational and economic incentives. This breach leads to the expropriation of employees' interests by the shareholders.

However, it should be noted that severance pay can alleviate employees' hardship in takeovers and compensate their loss of firm-specific investments.¹⁰⁹ Nevertheless, given the information and power asymmetries, workers can hardly bargain with the management and shareholders for satisfactory compensation. This is partially attributable to the shareholder primacy model adopted by Chinese corporate laws, which causes firms to be excessively inclined towards the interests of shareholders.

1.3.3 Shareholder Primacy Theory

Introduction to Shareholder Primacy

The third explanation of workers' vulnerability arises from the dominant corporate governance model, which is shareholder primacy. This theory requires directors to operate a company in the interests of its shareholders,¹¹⁰ which is the predominant model of corporate governance in the Anglo-American tradition. The idea of shareholder primacy is exemplified by the case of *Dodge v. Ford Co.*¹¹¹

A business corporation is organized and carried on primarily for the profit of stockholders. The powers of the directors are to be employed to that end. The discretion of directors is to be exercised in the choice of means to attend that end and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes.

¹⁰⁹ A. Shleifer and R.W. Vishny, "Value Maximization and the Acquisition Process" (1988) 2 *Journal of Economic Perspectives* 7.

¹¹⁰ D.G. Smith, "The Shareholder Primacy Norm" (1997) 23 *The Journal of Corporate Law* 277 at 278. Shareholder primacy theory is the mainstay of the corporate governance model, which requires management to operate exclusively in the interests of its shareholders.

¹¹¹ *Dodge v Ford Motor Co.* 170 NW 668 (Mich 1919) at 684.

As argued by Deakin, the theory of shareholder primacy originates in “the norms and practices surrounding the rise of the hostile takeover movement” in the 1970s and 1980s.¹¹² In the late 1950s and early 1960s, the hostile takeover was a comparatively new phenomenon. Faced with unwelcome takeovers, directors might reject the bid from outsiders without informing shareholders of the potential bid.¹¹³ Shareholders’ interests might yield to the overall company interests, especially considering that their control over corporate management was weaker due to the increasingly dispersed shareholder ownership. With the development of transparency and auditing rules, hostile takeovers became possible. In this context, by offering a premium over the current stock price, shareholders have the option to sell their shares and thereafter concede their control if they think they have no greater gains in the company than their financial investments. A changed managerial team which follows hostile takeovers is expected to focus on maximising the shareholders’ gains. Accordingly, in the takeover resolution, a series of institutional changes clarify the directors’ objective in the takeover, which change from the best interests of the company based on their understanding to giving advice to shareholders on the financial merits of the takeover bid. This is evidenced by the promulgation of the *City Code on Takeovers and Mergers* (1968) in the UK and the *William Act* (1968) in the US. In summary, the rise of hostile takeovers led to a change in directors’ mindset, along with the institutional revolution, which confirms contemporary shareholder norms.¹¹⁴

Theories of the Firm that Support Shareholder Primacy

Theories of the firm provide theoretical support for shareholder primacy, the first of which is the property rights theory. It has been long argued that the corporation is a type of property owned by the shareholders, because shareholders have “the rights to possess, use and manage, and the rights to income and capital”¹¹⁵ The rights of each shareholder represent only a fraction of the value of the overall property rights.

¹¹² S. Deakin, “The Coming Transformation of Shareholder Value” (2005) 13 *Corporate Governance: An International Review* 11.

¹¹³ L. Hannah, “Takeover Bids in Britain Before 1950: An Exercise in Business ‘Pre-History’” (1974) 16 *Business History* 65.

¹¹⁴ Smith (n 109) at 306.

¹¹⁵ M. A. Eisenberg, “The Conception That the Corporation is a Nexus of Contracts” (1999) 24 *Journal of Corporate Law* 819 at 825.

Accordingly, the directors (agents) appointed by the shareholders (principal) should manage the company solely for the interests of the shareholders because the shareholders' property rights are superior to those of other constituents.

The second theory that supports shareholder primacy is the nexus-of-contracts theory. It suggests that the firm is "a legal fiction which serves as a nexus for a set of contracting relationships among individuals".¹¹⁶ Generally, this theory rejects the notion that the corporation is a thing capable of being owned, and blurs the boundaries of the company.¹¹⁷ Accordingly, shareholders are not the owners of the corporation but the residual claimants to the corporation's assets and earnings.¹¹⁸ Specifically, the residual claimant generally means that after bearing the costs including the transaction costs,¹¹⁹ the agency costs,¹²⁰ and the costs of ownership,¹²¹ the shareholders enjoy the value of the residual claims of the corporation.¹²² "Those who do not bear risk on the margin get fixed terms of trade",¹²³ and their rights are established through "a mere bargained-for contract term".¹²⁴ This theory also lays the foundation for shareholder primacy. The shareholders hold a privileged position compared with other constituencies in the firm, since "for most firms the expectation is that residual risk bearers (shareholders) have contracted for a promise to maximize the long-run profits of the firm, which in turn maximizes the value of their stock".¹²⁵ The directors as the agents of the shareholders hold fiduciary duties to the shareholders, and "the obligation of corporate directors is to increase the value of the residual claim".¹²⁶

This ideology of the shareholder primacy theory can be explained as follows. The shareholders (the "principal"), acting as either the owner of the property of the firm or

¹¹⁶ Jensen & Meckling, (n 55) at 310.

¹¹⁷ M. C. Jensen and W. H. Meckling (n 55) at 311.

¹¹⁸ E.F. Fama and M. C. Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301.

¹¹⁹ R. H. Coase, "The Nature of the Firm" (1937) 4 *Economica* 386.

¹²⁰ Jensen & Meckling (n 55).

¹²¹ H. Hansmann, *The Ownership of Enterprise* (Harvard University Press-2009) 35.

¹²² Fama & Jensen (n 117).

¹²³ F. H. Easterbrook and D. R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press-1996) 36.

¹²⁴ S. M. Bainbridge, *The New Corporate Governance in Theory and Practice* (Oxford University Press-2008) 33.

¹²⁵ M. M. Blair and L. A. Stout, "A Team Production Theory of Corporate Law" (1999) 85 *Virginia Law Review* 247 at 249

¹²⁶ S. M. Bainbridge, *The New Corporate Governance* (n 123) 33.

the residual claimants, “have surrendered the right that the corporation should be operated in their sole interest”¹²⁷ to directors (the “agents”), thereby constituting the core principal–agent relationship in corporate governance. From the perspective of the shareholders, they have ultimate control over the management of the corporation and keep trying to reduce the agency costs arising from the directors’ management. On the other hand, the directors hold a fiduciary duty to the shareholders, of maximising the profits for the shareholders while avoiding shirking¹²⁸ and self-dealing.¹²⁹ In terms of the other constituencies, their interests “are only relevant to the degree that they contribute to the goal of attaining maximisation of the shareholders’ wealth”.¹³⁰ Although other constituencies may have contractual claims against the firm, the claim of the shareholder is at the heart of the firm.¹³¹

Shareholder Primacy in Hostile Takeovers and Employees’ Vulnerability

Hostile takeovers are perceived as “an engine of shareholder wealth maximisation”.¹³² Considering the disciplinary function as mentioned earlier, hostile takeovers provide a mechanism to align managers’ interests with those of shareholders.¹³³ Besides, hostile takeovers are compatible with shareholders’ interests in the context of more dispersed shareholding structures. This is because different groups of shareholders have widely divergent amounts of information and interests. Therefore, it is difficult for shareholders to monitor the management of the board of directors by hiring or firing members of the board, since the threshold of shareholding that is necessary to make such critical decisions can seldom be reached. However, hostile takeovers enable shareholders to overcome collective action problems, such as free-rider problems, as

¹²⁷ A. A. Berle and G. G. C. Means, *The Modern Corporation and Private Property* (Transaction Publishers-1991) 355.

¹²⁸ Shirking refers to the phenomenon that the directors shirk their responsibility to maximise the shareholder value with optimum efforts. See Kershaw, *Company Law in Context* (n 59) 179.

¹²⁹ Self-dealing refers to the fact that the directors enter into a transaction with the company that benefits themselves at the expense of the company. See Kershaw, *Company Law in Context* (n 59) 177.

¹³⁰ A. Keay, *The Enlightened Shareholder Value Principle and Corporate Governance* (Routledge-2013) 17.

¹³¹ Smith (n 109) at 278.

¹³² M.J. Roe, “The Shareholder Wealth Maximization Norm and Industrial Organization” (2001) 149 *University of Pennsylvania Law Review* 2063.

¹³³ J. Armour, S. Deakin, and S.J. Konzelmann, “Shareholder Primacy and the Trajectory of UK Corporate Governance” (2003) 41 *British Journal of Industrial Relations* 531.

well as to oust directors.¹³⁴ Incumbent dispersed shareholders have weak control over corporate management, and therefore it may be compatible with their best interests to sell their shares for a premium. Corporate raiders who gain control of target firms are able to replace the incumbent management to enhance the efficiency of corporations for better rewards. In addition, as stated earlier, hostile takeovers offer shareholders an opportunity to breach implicit contracts with stakeholders including employees, which enables them to expropriate the latter's rents. In hostile takeovers where shareholders have a decisive say and aim to pursue shareholder wealth, employees are vulnerable to unjust treatment from corporate raiders because their power is comparatively diminished, and consequently their interests are subordinated to those of the raiders.

The pursuance of shareholders' interests at the expense of other stakeholders in hostile takeovers has invited much criticism, which will be discussed in Chapter 2. Despite the criticism, shareholder primacy remains the dominant corporate governance theory and is also generally adopted by Chinese firms. This situation has arisen from China's "corporation without privatization" process of the late 1980s.¹³⁵ This aimed to reform the state-owned enterprises (SOEs) of the old planned economy. These SOEs were factories rather than companies in the capitalist economy. Their production was "based on administrative orders rather than competitive struggle between rival firms for profits and market share".¹³⁶ "Corporation" refers to the introduction of the modern enterprise system to Chinese SOEs. In this context, the party-state remained as the controlling shareholder without any "privatisation" or any real withdrawal from corporate governance. In this case, shareholder primacy can be seen as the primacy of the party-state in SOEs. Accordingly, the first Company Law as promulgated in 1994 adopted the model of shareholder primacy, which has been maintained till now and is adopted by other rules and regulations in China. It should be noted that these laws, rules, and regulations, which are characterised as shareholder-oriented and shareholder empowerment, can be also applied to private firms. With regard to the former, both

¹³⁴ L.A. Stout, "Bad and Not-so-Bad Arguments for Shareholder Primacy" (2002) 75 *Southern California Law Review* 1189.

¹³⁵ N.C. Howson, "Protecting the State from Itself: Regulatory Interventions in Corporate Governance and the Financing of China's 'State Capitalism'" in B.L. Liebman and C.J. Milhaupt (eds.), *Regulating the Visible Hand?: The Institutional Implications of Chinese State Capitalism* (Oxford University Press-2015) 50.

¹³⁶ P. Nolan, "Large Firms and Industrial Reform in Former Planned Economies: The Case of China" (1996) 20 *Cambridge Journal of Economics* 1.

the Company Law and the Code of Corporate Governance for Listed Companies in China require the board of directors to be accountable to the shareholders.¹³⁷ In takeovers, the board of directors is placed under fiduciary duties and duties of diligence to the firm and is required to safeguard the interests of shareholders.¹³⁸ As for the latter, shareholders enjoy a decisive power on vital issues such as the appointment or dismissal of non-employee directors and supervisors and in major transactions such as takeovers.¹³⁹ However, despite the fact that the pattern of share ownership is becoming more dispersed in China, it remains concentrated enough for majority shareholders to exert effective control over corporate governance and decision-making in hostile takeovers, at the expense of employees' interests.¹⁴⁰ Admittedly, there are certain rules that require other constituencies' interests also to be considered; for instance, the interests of creditors and employees are to be safeguarded as a part of corporate governance.¹⁴¹ However, this does not naturally lead to the Chinese laws adopting a different corporate governance model from shareholder primacy. Since most banks are state owned and workers - theoretically at least - are deemed to be the leaders of the state according to Chinese Constitutional Law, these arrangements can be explained more as safeguarding the party-state's interests rather than as adopting a different model. Moreover, these rules provide no effective enforcement mechanism, making them rarely implementable in practice. This is supported by a survey conducted by Weng, who found that although corporate social responsibility is emphasised in corporate management, most Chinese practitioners perceive a company as the property of the shareholders, and accordingly their interests are prioritised over those of all other constituencies.¹⁴²

The shareholder primacy model adopted by Chinese corporate laws causes firms to be inordinately inclined towards the interests of shareholders. This makes workers

¹³⁷ Article 46 of the *Company Law of People's Republic of China* (《中华人民共和国公司法》) (The Company Law of PRC) and Article 8 of the *Code of Corporate Governance for Listed Companies* (《上市公司治理准则》) (2002).

¹³⁸ Article 8 of *Takeover Measures*.

¹³⁹ Article 37 and 99 of the *Company Law of PRC*.

¹⁴⁰ For instance, according to the statistics collected by CSMAR Solution, by the end of 2014, the largest shareholders with shareholding exceeding 50% accounted for nearly 20% of listed companies, available at <http://www.gtarsc.com>.

¹⁴¹ Articles 37 and 99 of the *Company Law of PRC*.

¹⁴² C.X. Weng, "Inside or Outside the Corporate Law Box? Shareholder Primacy and Corporate Social Responsibility in China" (2017) 18 *European Business Organization Law Review* 155.

vulnerable to unjust treatment, especially in the context of takeovers. However, it should be noted that addressing shareholders' concerns to the exclusion of other stakeholders may not positively affect firm value or shareholders' interests in the long run. In addition, whether the maximisation of shareholder value is the only objective of firm management should be open to question. These criticisms of shareholder primacy are discussed in Chapter 2.

1.4 Conclusion

The vulnerability of employees in hostile takeovers as discussed in this chapter lies in three aspects. Due to the corporate governance model of shareholder primacy adopted by Chinese firms, corporate management is devoted to furthering the interests of shareholders. Therefore, in the context of takeovers, implicit contracts between the employer and employees are expected to be breached to attain the end of shareholder value maximisation. This is especially the case in hostile takeovers, when the obstacle to a breach of implicit contracts is removed. Since new management are not bound by the reputation of trustworthiness of the outgoing management, they are more willing to maximise shareholders' interests at the expense of the welfare of employees. As a result, employees tend to be confronted with unfavourable treatment, such as job losses or wage cuts. Considering that hostile takeovers are projected to rise in China, more workers are expected to experience negative treatment, which is a problem that needs to be resolved before it spirals out of control.

The vulnerability of workers in hostile takeovers leads to the requirement for strong labour protection mechanism. However, in addition to employees' demands, it seems that improving labour protection and participation aligns with firm interests too, which is a point that will be developed in Chapter 2.

Chapter 2: Theoretical Foundations for Employee Protection and Participation in Hostile Takeovers

Various theories can be used to seek a stronger labour protection mechanism in hostile takeovers. The first category is corporate governance models that are opposed to shareholder primacy, asserting that other stakeholders' interests should also be considered by directors. The second arises from economic considerations, holding that taking employees' interests into consideration in hostile takeovers, especially to deepen their involvement, aligns with firms' interests. Both categories are examined in this chapter, in order to justify how employee protection and involvement in hostile takeovers aligns with firm interests.

2.1 Challenges to Shareholder Primacy and other Corporate Governance Models

The ideology of shareholder primacy has not been left unchallenged. Its dominance in corporate governance theory requires corporate management to prioritise shareholders' interests at the expense of those of other stakeholders, including employees. In hostile takeovers, directors are encouraged to neglect employees' claims, especially when they conflict with the shareholders' interests. This is against business ethics, such as the ethics applicable to business situations, which may vary in different cultures.¹⁴³ Such codes require the management of a corporation to act ethically and take into account anyone who might be affected by their actions and decisions. Accordingly, in the context of takeovers, employees' interests should be given reasonable consideration, even though they may sometimes be considered an obstacle to takeovers. It should be noted that in terms of relations with other stakeholders, shareholder primacy holds that "maximizing profits for equity investors assists the other constituencies automatically".¹⁴⁴ This relates shareholders' value to firm value. Accordingly, since maximising firm value will lead to a wealthy firm, which is more

¹⁴³ B. Tricker and G. Tricker, *Business Ethics: A Stakeholder, Governance and Risk Approach* (Routledge-2014) 7.

¹⁴⁴ Easterbrook & Fischel, *The Economic Structure* (n 122) 38.

likely to provide employees with better welfare, both shareholders' and other constituencies'—including employees—interests are addressed. However, this may be true in certain circumstances only, and may not be valid for hostile takeovers. As mentioned in Chapter 1, there is no clear evidence showing that target firms improve their performance after takeovers, whereas incumbent shareholders quit such firms with a premium over the share price. Consequently, employees are exposed to the expropriation of rents in this process.

Theories of the firm that support shareholder primacy have also been challenged. As to the property rights theory, its support of shareholder primacy does not necessarily lead to directors' neglect of employees' interests. First, the property right is not unrestricted,¹⁴⁵ since directors should also serve the interests of stakeholders other than shareholders, for ethical reasons. This leads to the notion that the corporation should be managed without harming the basic interests of other stakeholders. Accordingly, in the context of takeovers, the transfer of control of the firm can be deemed as a transfer of property rights by shareholders. Although the new owners (new shareholders) have the right to dispose of the newly gained property (the firm), this should not be contrary to the employees' basic welfare. Second, property rights should be understood within the context of the fundamental idea of distributive justice, and the principles of distribution can be pluralistic. This argument is adopted to support the idea that the shareholders are not the only owners. This is because "the property consists of a bundle of rights which the owner of property possesses with regard to something- rights to possess, use, dispose of, exclude others, and manage and control",¹⁴⁶ and different rights of the property of the firm can be distributed to different groups of stakeholders based on different principles. For instance, the property can be distributed to the shareholders according to their financial investment, while long-standing employees can have property distributed according to their human capital. In this regard, employees are also perceived as owners of the firm. In the case of a change of the controlling shareholders, the interests of employees as co-owners of the firm should be reasonably addressed based on their investment (of human capital, etc.) in the firm.

¹⁴⁵ R. H. Coase, "the Problem of Social Cost" (1960) 3 *Journal of Law and Economics* 44.

¹⁴⁶ D. Votaw, *Modern Corporations* (Prentice-Hall-1965) 96.

According to the nexus-of-contracts theory, the relationship of stakeholders with the firm is contractual, whereas shareholders are the residual claimants. However, it does not naturally follow from this claim that the non-contractual relationships of stakeholders should not be considered by directors. To begin with, the concept of contracting needs to be broadly interpreted to include legal and moral issues. This argument recognises the incompleteness of contracts, and the use of corporate laws¹⁴⁷ and morality to fill the gaps in open-ended contracts. This supplementation to the contract incorporates the legal, and in particular moral, factors into directors' management practices, making it compatible with the stakeholder theory. Second, stakeholders incur costs in contracting with firms. In particular, the representatives rather than the contractors themselves negotiate the contracts,¹⁴⁸ and this relationship is similar to the principal–agent relationship, incurring agency costs. Combined with the inequality between the stakeholders and the company, the responsibility of the directors should not be limited to performing the terms of the contracts but must also include reducing the agency costs and procuring fair bargaining in contracting. Third, the shareholders are in reality only rarely the only residual claimants. For instance, employees who make human capital investments in the company can also be deemed to be residual claimants,¹⁴⁹ or stakeholders' residual claims can be attained from contracts ex ante.¹⁵⁰ In sum, any constituency that makes firm-specific investments in the firm can be treated as a residual claimant.

In this discussion, the incomplete contract theory seems relevant. It posits that a set of contracts cannot capture or fully explain the complexity of relationships in a firm.¹⁵¹ This is because parties cannot fully anticipate everything in contracting ex ante, whereas some of the non-specified conditions cannot be contracted ex post. Accordingly, there should be some mechanism to fill the gaps or to deal with ambiguities in the contracts, in which discretion should be given to those who have

¹⁴⁷ Easterbrook & Fischel, *The Economic Structure* (n 122) 35.

¹⁴⁸ Easterbrook & Fischel, *The Economic Structure* (n 122) 16.

¹⁴⁹ M. M. Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-first century* (The Brookings Institution-1995) 238.

¹⁵⁰ J. R. Macey, "Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective" (1999) 84 *Cornell Law Review* 1266 at 1281.

¹⁵¹ Grossman and Hart (n 80).

residual rights of control, which relate closely to the ownership of the corporation.¹⁵² In this case, it appears that the corporation is deemed a combination, being a nexus of contracts as well as a type of property. As identified by Bainbridge, “business organization law does have elements of property law, as well as contract law.”¹⁵³ According to the incomplete contract theory, there are two relations, namely contractual relations and property rights relations. The contractual relationship is described first.

One feature of contracts is that the relationship between a company and its stakeholders are bidirectional, which means that both parties to the contracts must fulfil duties to the other. Those who have contracts with the firm (shareholders, employees, creditors, suppliers, customers, the government, etc.) should comply with their rights and duties contracted beforehand based on fair negotiation and bargaining, while the conditions that are or cannot be specified should be clarified in accordance with their relevant residual rights of control. Those parties to the contract, in particular, who have all the residual rights of control over the non-specified actions tend to favour themselves, which is cause for major concern to the other parties. In a corporation, the shareholders are deemed to be the owner of property of the corporation, giving them the residual rights of control. Thus, other constituencies who do not have the residual rights of control may withhold some of the contract-specific investments for risk averse purposes. This is especially the case with regards to the employer-employee relationship. There is asymmetry between the employer and employees because the latter is economically dependent on the former,¹⁵⁴ and “many details of the job to be carried out are left to the employer’s discretion.”¹⁵⁵ Employees who are aware of their inferior residual rights of control over the shareholders may be reluctant to make contract-specific investments fearing their potential loss of benefits in non-specified conditions. Therefore, the residual rights of control held by shareholders, which are

¹⁵² The residual right of control refers to the right to “control all aspects of the asset that have not been explicitly given away by contract.” This right is fully illustrated in O. R. Hart, “In Complete Contracts and the Theory of the Firm” (1988) 4 *Journal of Law, Economics & Organization* 119 at 123.

¹⁵³ S. M. Bainbridge, *The New Corporate Governance* (n 123) 32.

¹⁵⁴ B. Baudry and V. Chassagnon, “The Analysis of Employment Relationship in Contract Economic Theories: A Critical Review Based on the Nature of American and French Labor Law” (2018) 27 *Economie et Institutions*, available at <https://journals.openedition.org/ei/6127#tocto3n1>.

¹⁵⁵ S. Peck and P. Temple, *Mergers and Acquisitions: Motivation* (Routledge-2002) 147.

conferred by their ownership of the property of firm, are detrimental to the benefits of the employer and employees. Accordingly, in order to achieve the optimal benefits of the contract, employees should be granted some of the residual rights of control.¹⁵⁶ The theoretical basis of this allocation can be examined from the property relationship perspective of the firm.

The owners of the property of the firm are perceived to have the residual rights of control. In addition to shareholders who make capital investments in the firm, other stakeholders, especially employees, also have property rights. Based on the fundamental idea of distributive justice, the principles of distribution can be pluralistic. This is because “the property consists of a bundle of rights which the owner of property possesses with regard to something- rights to possess, use, dispose of, exclude others, and manage and control,”¹⁵⁷ and different rights of the property of the firm can be distributed to different groups of stakeholders based on different principles. For instance, a property can be distributed to the shareholders according to their capital investment, while long-standing employees can have the property distributed according to their human capital. In this regard, employees can be allocated residual rights of control due to their ownership of the firm. However, it should be noted that although employees have property rights and accordingly residual rights of control, these rights are inferior to those of shareholders. Therefore, the property rights of shareholders should be subject to certain restraints.¹⁵⁸ The restraints that can be suggested that include laws and regulations, such as corporate law, labour law, and environmental law. Other restraints involve business ethics or, more precisely, corporate social responsibility (CSR).¹⁵⁹ Faced with pressures linked to environmental, political, and social factors, business ethics require the management of a corporation

¹⁵⁶ Grossman & Hart (n 80).

¹⁵⁷ D. Votaw, *Modern Corporations* (Prentice-Hall-1965) 96.

¹⁵⁸ The restraints can be various, and one should be business ethics, see R.E. Freeman, J. S. Harrison, J. S., A.C. Wicks, B.L. Parmar, and S. De Colle, *Stakeholder Theory: The State of the Art* (Cambridge University Press-2010) 195-234.

¹⁵⁹ In practice, and as confirmed by various scholars, laws business ethics and CSR are applied throughout corporate governance, rather than only to restricted relationships in the corporation. For instance, see K. E. Goodpaster, “Business Ethics and Stakeholder Analysis” (1991) 1 *Business Ethics Quarterly* 53. Here I suggest that the fact that business ethics can be applied to the property rights relationship does not exclude the application in other relationships.

to act ethically and consider anyone who may be affected by their actions and decisions.¹⁶⁰

In the context of hostile takeovers, employees should be allocated extra rights from the perspective of the contractual relationship as well as the property relationship. For the former, hostile takeovers lead to the risk of a breach of implicit employment contract. This has been discussed in detail in section 1.2.2. Meanwhile, massive lay-offs, which are commonly observed in hostile takeovers, lead to employees' loss of property rights. Therefore, it should be noted that the incomplete contract theory provides the theoretical grounds for employee involvement in hostile takeovers' decision making.

Recognising the flaws of shareholder primacy and inspired by the development of theories of the firm, three leading theories on corporate governance models are examined in this section. The first is enlightened shareholder value (ESV), which can be presented as something of a modification of shareholder primacy. It similarly prioritises shareholders' interests, albeit over the long term. Therefore, interests of corporate constituencies should be considered. The second is the team production theory, which perceives a public corporation as a team of members who make specific investments in the firm for mutual gains. Accordingly, workers as team members should be fairly treated by management. The third is stakeholder theory, which is diametrically opposed to shareholder primacy. It asserts that the furtherance of shareholders' interests should not be understood as the sole objective of the directors, and therefore directors should be accountable to different stakeholder groups as a whole. All these models have systemic flaws if presented as univocal foundations or models of corporate governance, but they do provide a response to the criticisms of shareholder primacy, and veer towards relatively more stakeholder oriented corporate governance models. These models, accordingly, lay potential theoretical foundations for employees to express their claims for fairer treatment. This chapter examines these

¹⁶⁰ Y. Pesqueux, "Corporate Social Responsibility: The Exhausting of a Management Topic" in A. Tencati and F. Perrini (eds), *Business Ethics and Corporate Sustainability* (Edward Elgar Publishing Limited-2011) 46.

theories, with an emphasis on their systemic disadvantages and advantages with regard to labour protection.

2.1.1 Enlightened Shareholder Value

“Enlightened shareholder value” can be understood in terms of the proposition that addressing shareholders’ concerns to the exclusion of other stakeholders does not positively affect shareholders’ interests in the long run.¹⁶¹ It can be contrasted with shareholder primacy theory. To be specific, shareholder primacy inculcates in directors a short-term focus on shareholders’ interests, which can be deleterious for various other groups including employees, and even for the long-term wellbeing of the company.¹⁶² Accordingly, enlightened shareholder value theory claims that “managers should make all decisions so as to increase the total long-run market value of the firm.”¹⁶³

The concept of enlightened shareholder value states that the corporation should be managed exclusively for the interests of shareholders. It aligns the shareholders’ interests with stakeholders’ claims while recognising the diversity of shareholder and other constituencies’ interests.¹⁶⁴ This theory holds that the corporation should be managed exclusively for the interests of shareholders, as “shareholders are the only stakeholders of a corporation who simultaneously maximize everyone’s claim in maximizing their own”.¹⁶⁵ In hostile takeovers, enlightened shareholder value “allows directors leeway to take into account the interests of non-shareholder constituencies”,¹⁶⁶ as long as these are compatible with firm welfare and shareholders’ long-term interests.

¹⁶¹ Deakin (n 111).

¹⁶² L.E. Mitchell, *Corporate Irresponsibility: America’s Newest Export* (Yale University Press-2001) 185.

¹⁶³ M. C. Jensen, “Value Maximization, Stakeholder Theory, and the Corporate Objective Function” (2002) 12 *Business Ethics Quarterly* 235.

¹⁶⁴ V. H. Ho, “‘Enlightened Shareholder Value’: Corporate Governance beyond the Shareholder- Stakeholder Divide” (2010) 36 *Journal of Corporate Law* 59 at 62.

¹⁶⁵ T. Copeland, T. Koller and J. Murrin, *Valuation, Measuring and Managing* (John Wiley-2010) 22.

¹⁶⁶ S. Deakin, R. Hobbs, D. Nash, and G. Slinger, “Implicit Contracts, Takeovers and Corporate Governance: in the Shadow of the City Code” (2002) *ESRC Centre for Business Research, University of Cambridge Working Paper* 254, available at

https://www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp254.pdf.

On the other hand, compared to shareholder primacy, enlightened shareholder value is stakeholder oriented. The managers have to make decisions while accounting for the interests of all stakeholders in their firm, as stakeholders can substantially influence the welfare of the corporation. Accordingly, this approach values the building of long-term relationships, which requires directors to strike a balance between the competing interests of different stakeholder groups.¹⁶⁷

The UK adopted the ESV theory in the Companies Act 2006,¹⁶⁸ which requires directors to have regard for a range of interests, including employees', in order to promote the success of the company. It can be presented as a modification of shareholder primacy, where similarly directors with shareholder oversight remain the core decision-making authority.¹⁶⁹ However, it should be noted that there is no effective enforcement mechanism for workers if directors do not consider their interests. In addition, there are some practical difficulties in implementing the enlightened shareholder value theory. First, although shareholders' interests should be prioritised under the enlightened shareholder value, by providing directors with relatively clear guidance to manage the company in terms of other stakeholders, the directors are still empowered to exercise their own preferences in distributing attention and resources to different groups of stakeholders, leading to the "two master problem",¹⁷⁰ which means that "a manager told to serve two masters has been freed of both and is answerable to neither. Faced with a demand from either group, the manager can appeal to the interests of the other". If the discretion of allocating resources between different stakeholder groups is left exclusively to the directors in takeovers, without an effective mechanism to consult employees as well as other stakeholders of the firm, their interests will not be considered properly. Second, as the most influential constituency in a firm, who has the power to elect and dismiss directors, undoubtedly shareholders' interests should be given a large measure of attention by the directors in almost every case, which means there is no real difference from shareholder primacy.

¹⁶⁷ The Company Law Review Steering Group, Department of Trade and Industry, "Modern Company Law for a Competitive Economy: Developing the Framework" (2000) 15.

¹⁶⁸ Section 172 of *the Companies Act 2006 of the United Kingdom*.

¹⁶⁹ Ho (n 163) at 62.

¹⁷⁰ Easterbrook & Fischel, *The Economic Structure* (n 122) 38.

This is especially the case in hostile takeovers, where UK laws protect employees' information rights but reject workers' participation in decision making regarding takeovers.¹⁷¹

In terms of the ESV, the short-term focus on shareholder interests tends to overshadow other constituencies of the firm, and the firm and shareholders are negatively affected in the long run. Therefore, all stakeholders' claims should receive the consideration of directors in corporate governance. This is particularly important in hostile takeovers, where incumbent shareholders have a strong incentive to maximise their short-term interests at the expense of other stakeholders. In order to alleviate the negative impacts of hostile takeovers on the interests of the firm, the claims of stakeholders, including employees, should be considered by the directors. However, according to this theory, the extent to which employee interests should be considered remain at the discretion of directors. This leads to practical difficulties as evidenced in the UK laws that have adopted enlightened shareholder value theory. Inspired by this theory, this thesis advances the claim that in order for management to be accountable to employees in hostile takeovers, where the latter are vulnerable to unjust treatment, an effective mechanism should be established involving employees in corporate decision making.

2.1.2 Team Production Theory

The team production theory is revolutionary, in comparison with the ESV approach. According to the team production theory, the public corporation is "a team of people who enter into complex agreement[s] to work together for their mutual gain".¹⁷² In other words, this public corporation is "a nexus of firm-specific investments made by many and varied individuals who give up control over those resources to a decision-making process in the hopes of sharing in the benefits that can flow from team production".¹⁷³

¹⁷¹ Section 2.7, 2.11, 24.1, 25.9 and 32.6 of *the City Code*.

¹⁷² Blair & Stout (n 124) at 278.

¹⁷³ Blair & Stout (n 124) at 285.

In terms of corporate governance, the team production theory suggests a mediating hierarchy model.¹⁷⁴ Specifically, there are layers of hierarchy within the firm, with the hierarchy at the highest levels having the responsibility to encourage firm-specific investments, monitor shirking and rent seeking,¹⁷⁵ and to resolve disputes among members at the lower levels. Accordingly, the board of directors, which has the ultimate decision-making authority and full discretion to mediate conflicts of team members with different interests, acts as the top hierarchy structure.¹⁷⁶ In this case, the directors cannot act as the agents of the shareholders, but as trustees of the corporation, or more precisely of the team members. However, in realising the supremacy of the directors, the team production theory does not deem it necessary to monitor the directors, since directors relate their interests and reputation with the firm, and therefore can be restricted by legislation and norms of fairness and trust.¹⁷⁷

The team production theory is insightful, because it describes corporate governance from a refreshingly new perspective. The interests of firms' constituents are based on their firm-specific investments,¹⁷⁸ and accordingly a firm can be deemed as a nexus of firm investments. This is distinguished from the property rights and the nexus-of-contract theories. Relationships between directors and shareholders and other stakeholders are deemed as based on trust, which is different from the agency relationship as described in other corporate governance models. However, directors, who have superiority in corporate governance, are accountable to all members in the team, which also therefore leads to the "two master problem". In addition, the theory has some systemic flaws.¹⁷⁹ For instance, the production team are defined as "a collection of individuals who are interdependent in their tasks, who share responsibility for outcomes, [and] who see themselves and who are seen by others as

¹⁷⁴ Blair & Stout (n 124) at 276-286.

¹⁷⁵ Shirking occurs when team members fail to make optimum efforts to exert their responsibility to achieve joint success while rent seeking means team members seek to compete for the fixed amount of wealth, which is costly in terms of the resources, time and money.

Blair & Stout (n 124) at 290-292.

¹⁷⁷ Blair & Stout (n 124) at 315-319.

¹⁷⁸ Blair & Stout (n 124) at 295.

¹⁷⁹ See M. M. Bainbridge, "The Case against Blair & Stout's Team Production Model" (2015), available at <http://www.professorbainbridge.com/professorbainbridge.com/2015/01/the-case-against-blair-stouts-team-production-model.html>; Also see R. Harris, "The History of Team Production Theory" (2014) 38 *Seattle University Law Review* 537.

an intact social entity embedded in one or more larger social systems”¹⁸⁰ This definition perceives the tasks of team members as inseparable, but this does not comply with the reality of large firms where the firm’s constituencies may have separable tasks rather than inseparable. It also cannot adequately explain the corporate governance of firms with a dominant shareholder or other dominant constituent, considering that the directors will struggle to play a mediating role in such a case.¹⁸¹

Under the team production theory, the directors hold fiduciary duties to the corporation, and accordingly to all team members of the firm. Therefore, in hostile takeovers, corporate management have the responsibility to resist the potential takeover if it is compatible with the benefit of all members. If the takeover is hostile and favoured by shareholders, the directors are obliged to address the conflict between shareholders who want to obtain a premium over their shares and stakeholders such as employees who are in pursuit of stable employment. However, this may prove difficult in practice, as directors are also expected to be negatively affected by the potential takeover. This makes them lose their neutral role as a mediator in dealing with conflicts between shareholders and employees. Therefore, at least in hostile takeovers, directors should not be endowed with the discretion to address the conflicts of team members at lower levels of the hierarchy.

In conclusion, the team production theory provides two implications for workers’ involvement in hostile takeovers. First, as team members who contribute to the team production, employee claims should be considered to encourage their firm-specific investments. This positively affects the firm’s welfare. Second, since directors are incompetent to act as mediators in addressing conflicts between shareholders and employees, there is a risk that directors may take advantage of employee claims to safeguard their personal interests. Therefore, it is necessary to establish a mechanism for workers to make themselves heard by shareholders without intervention of directors.

¹⁸⁰ S.G. Cohen and D.E. Bailey, “What Makes Teams Work: Group Effectiveness Research from the Shop Floor to the Executive Suite” (1997) 23 *Journal of Management* 239.

¹⁸¹ J.C. Coates, “Measuring the Domain of Mediating Hierarchy: How Contestable are US Public Corporations” (1998) 24 *Journal of Corporate Law* 837.

2.1.3 Stakeholder Theory

As a theory distinct from shareholder primacy,¹⁸² stakeholder theory claims that the corporation is required to serve a wider range of interests, which are not subordinate to shareholder value.¹⁸³ In light of increasing business turbulence in the western world, globalisation, and ethics becoming a routine factor in a manager's job, less shareholder-oriented corporate governance models were formulated in the 1980s.¹⁸⁴ Stakeholder theory was one of the leading theories among these more egalitarian governance models. It cares more about business ethics while focusing on value and trade creation and changing the mindset of the managers.¹⁸⁵ The idea of this theory can be dated back to Adam Smith,¹⁸⁶ who raised the concept of "justice and beneficence" in business practices. According to these scholars, employees have intrinsic value. This is because management decisions, especially those relating to takeovers, significantly influence the work environment and conditions, thereby shaping workers' personalities and life. Hence, they deserve to be treated with dignity and fairness.¹⁸⁷ Accordingly, directors' fiduciary obligations transcend shareholders' short-term interests and are subject to moral duties in their execution, and in any case they go beyond mere compliance with laws.¹⁸⁸ In addition, in the long-run, companies with a record of ethical management are observed to outperform competitors that lack this focus.¹⁸⁹

Definition of Stakeholders

¹⁸² A. Keay, *The Corporate Objective* (Edward Elgar Publishing-2011) 331.

¹⁸³ R. E. Freeman and W. M. Evan, "Corporate governance: A stakeholder interpretation" (1990) 19 *Journal of Behavioral Economics*, 337 at 338.

¹⁸⁴ R.E. Freeman, *Strategic management: A Stakeholder Approach* (Cambridge University Press-2010).

¹⁸⁵ Freeman et al, *Stakeholder Theory* (n 157) 3.

¹⁸⁶ A. Smith, *The Theory of Moral Sentiments* (Penguin-2010) 70.

¹⁸⁷ J.J. McCall, "Employee Voice in Corporate Governance: A Defense of Strong Participation Rights" (2001) 11 *Business Ethics Quarterly* 197.

¹⁸⁸ K.E. Goodpaster, "Business Ethics and Stakeholder Analysis" (1991) 1 *Business Ethics Quarterly* 53.

¹⁸⁹ M.B.E. Clarkson, "A Stakeholder Framework for Analysing and Evaluating Corporate Social Performance" in M.B.E. Clarkson (ed), *the Corporation and Its Stakeholder: Classic and Contemporary Readings* (University of Toronto Press-1998) 243.

Stakeholder theory arguably has remained underdeveloped, since the scholarship on stakeholders is a “content free” field with “a muddling of theoretical bases and objectives”.¹⁹⁰ Scholars have not even reached agreement on the definition of stakeholders. On the other hand, no matter how employees are defined, without doubt they fall into the category of “stakeholders”. However, the definition of stakeholders determines employees’ relationship with the firm, which affects how they should be treated in corporate governance theory.

One of the most cited concepts connects the stakeholders with the corporation through “affect” and “affected by”, defining a stakeholder as “any group or individual who can affect or is affected by the achievement of the organization’s objectives”.¹⁹¹ This definition is so broad that it is capable of including virtually anyone, or any group, within the scope of stakeholders. Almost anyone who indirectly or incidentally relates to the firm or even anyone who thinks they are affected by the firm can be defined as a stakeholder under this definition. In this way, the notion of the stakeholder “risks becoming a meaningless designation”.¹⁹² Other researchers see the stakeholders’ connection with the company as one that is “dependent for its (the organisation’s) continued survival”.¹⁹³ This definition greatly narrows down the scope of the “stakeholders” and highlights the necessity of the stakeholders for the corporation. However, the “survival” standard is obviously too narrow a definition, since it may exclude many recognisable stakeholders in terms of our common intuition. For instance, in the event of a corporate crisis, employees may face redundancy if their employers cut costs. However, when these former employees are laid off, they are no longer dependant on the firm for survival, and are therefore excluded from the definition of “stakeholders”. This finding would follow from the organisational survival logic, plainly runs counter to the ethical basis of the stakeholder theory. There

¹⁹⁰ T. Donaldson and L. E. Preston, “The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications” (1995) 20 *Academy of Management Review* 65 at 73.

¹⁹¹ Freeman et al, *Stakeholder Theory* (n 157) 46.

¹⁹² Freeman et al, *Stakeholder Theory* (n 157) 207.

¹⁹³ The first concept of the stakeholder as identified by R.E. Freeman in 1984, was made by the Stanford Research Institute in 1963, which was “those groups without whose support the organization would cease to exist.” See Freeman, *Strategic Management* (n 183) in 1984 (Reprinted in 2010) 34. R.E Freeman defined stakeholders as “any identifiable group or individual on which the organization is dependent for its continued survival.” See R.E. Freeman and D.L. Reed, “Stockholders and Stakeholders: A New Perspective on Corporate Governance” (1983) 15 *California Management Review*. 88 at 91.

have been many other attempts to forge an appropriate definition of the stakeholder. Based on different concepts, the stakeholders' connection with the firm can be rooted in contract,¹⁹⁴ an exchange,¹⁹⁵ legal title, a legal right, a moral right,¹⁹⁶ an at-risk status,¹⁹⁷ or interest in the harm and benefit generated by corporate activity and conduct.¹⁹⁸ It is difficult to synthesize or harmonise these different accounts. This is because these definitions are made under different contexts. With regard to those commentators who have tried to expand the scope of the theory by including almost everything within the ambit of stakeholders,¹⁹⁹ the stakeholder is defined in a macro-political context. Meanwhile, other commentators deem the stakeholder theory as a strategic management approach, and as such practicability counts. Moreover, stakeholder theory is dynamic rather than static,²⁰⁰ considering the constantly changing circumstances both outside and inside companies.

Having realised these difficulties, scholars have turned to focus on the attributes of the stakeholder: (1) the stakeholder's power to influence the firm; (2) the legitimacy of the stakeholder's relationship with the firm; and/or (3) the urgency of the stakeholder's claim on the firm.²⁰¹ With regard to attribute (2), inspired by the incomplete contract theory, the legitimacy of employees' relationship with the firm arises from their employment contract with firms and their human capital input in the firm. In the context of hostile takeovers, employees are vulnerable to unjust treatment, which resonates with attribute (3). Accordingly, the extent to which workers' interests are

¹⁹⁴ Freeman and Evan (n 182). The stakeholders are those who have explicit or implicit contracts with the firm.

¹⁹⁵ For example, in Blair, *Ownership and Control* (n 148) 202. The corporation should serve parties who have contributed inputs to the enterprise, and who as a result, have at risk investments that are highly specialized to the enterprise.

¹⁹⁶ A. B. Carroll, *Business and Society: Ethics and Stakeholder Management* (Cincinnati: South-Western-1989) 57. The stakes can be "ranging from an interest to a right (legal or moral) to ownership or legal title to the company's assets or property".

¹⁹⁷ E.W. Orts and A. Strudler, "The Ethical and Environmental Limits of Stakeholder Theory" (2002) 12 *Business Ethics Quarterly* 215 at 218. Stakeholders are "participants in a business (who) have some kind of economic stake directly at risk".

¹⁹⁸ Donaldson & Preston (n 189) at 85. Stakeholders can be "identified through the actual or potential harms and benefits that they experience or anticipate experiencing as a result of the firm's actions or inactions".

¹⁹⁹ M. Starik, "Should Trees Have Managerial Standing? Toward Stakeholder Status for Non-human Nature" (1995) 14(3) *Journal of business ethics* 207. The stakeholders can even include non-human entities.

²⁰⁰ V. Luoma-aho and M. Vos, "Towards a More Dynamic Stakeholder Model: Acknowledging Multiple Issue Arenas" (2010) 15 *Corporate Communications: An International Journal* 315 at 316.

²⁰¹ R. K. Mitchell, B. R. Agle, and D.J. Wood, "Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts" (1997) 22 *Academy of management review* 853 at 865.

taken care of in takeovers depends on their power to influence the takeover decision based on attribute (1). In this case, a mechanism that empowers workers is needed, in order to safeguard their rights in the process of takeovers.

Treatment of Workers in Hostile Takeovers

Stakeholder theory provides workers with a theoretical basis to put forward their views on the potential takeover and to negotiate terms and conditions of employment contracts comparatively fairly and equally. As to the intensity of legal intervention to enhance labour protection, there are three levels posited by scholars:²⁰² 1) stakeholders should be treated fairly and with respect; 2) the interests of stakeholders should be considered; 3) stakeholders should participate in corporate decision-making processes. Influenced by this theory, thirty states of the United States have so far adopted corporate constituency statutes, which allow officers and directors to give weight to the interests of all stakeholders, including employees, in addition to performing their fiduciary duties to shareholders.²⁰³ They were widely criticised by scholars, since incumbent managers might use them to entrench themselves. This might explain the poor appeal of these statutes in courtrooms, considering that managers tended to use takeover defence tactics to retain their jobs. As a result, these constituency statutes have not performed as effectively as expected.²⁰⁴ Another example that is related to stakeholder theory is the German co-determination mechanism. Unlike the UK and US laws which leave it to the discretion of directors to take employees' claims into account, German corporations have established a practicable and effective mechanism to respond to employees' claims in corporate takeovers. Employees deserve to have a voice in the context of takeovers.²⁰⁵ Accordingly, this thesis uses this proposition as a role model to resolve the issue of the currently ineffective protection of employees in takeovers. Accordingly, a more detailed examination is made in Chapter 4.

²⁰² J. Henry, "Missing the Target: Normative Stakeholder Theory and the Corporate Governance Debate" (2001) 11 *Business Ethics Quarterly* 159 at 167.

²⁰³ J.D. Springer, "Corporate Constituency Statutes: Hollow Hopes and False Fears" (1999) 85 *Annual Survey of American Law* 95.

²⁰⁴ B. McDonnell, "Corporate Constituency Statutes and Employee Governance" (2004) 30 *William Mitchell Law Review* 1227.

²⁰⁵ R. Dahl, *A Preface to Economic Democracy* (University of California Press-1985) 111.

Stakeholder theory provides an inspiring theoretical foundation for employee protection in hostile takeovers. However, the relationship between employees and directors has not been clarified. Some put forth the stakeholder agency theory,²⁰⁶ arguing that the connection between the directors and employees parallels the principal–agent relationship between shareholders and employees. Such a parallel seems misconceived. This is because in an agency relationship the agent’s authority comes from the principal. In corporate governance, employees do not have effective powers to appoint or dismiss directors. It should be noted that workers in China have the right to elect employee members on the board of directors of companies, which may constitute the agency relationship. However, as examined in Chapter 3, these elected directors can hardly represent workers’ interests and they are unable to make any difference in the decision making of the board of directors even when they speak for employees. In addition, even if the connection between employees and directors constitutes an agency relationship, directors may also have a relationship with other stakeholders such as shareholders and creditors, which again leads to the “two masters problem”.

Others scholars raise the “fiduciary stakeholder principle” by holding that like the fiduciary duty that directors have towards the shareholders, they also owe such a duty to stakeholders.²⁰⁷ However, critics argue that a fiduciary duty to stakeholders other than the shareholders may damage the moral basis of the “fiduciary”.²⁰⁸ More specifically, shareholders exhibit control vulnerability and information vulnerability to managers. The two types of vulnerability constitute the moral basis for directors’ fiduciary duty towards shareholders. The shareholders do not have enough information to evaluate corporate management, and even if they have such information, they normally lack the wisdom to evaluate the management’s decisions. Therefore, directors’ fiduciary duties to shareholders are morally significant. In comparison,

²⁰⁶ C. W. L. Hill and T. M. Jones, “Stakeholder Agency Theory” (1992) 29 *Journal of Management Studies* 131.

²⁰⁷ R. E. Freeman, “The Politics of Stakeholder Theory: Some Future Directions” (1994) 4 *Business Ethics Quarterly* 409.

²⁰⁸ A. M. Marcoux, “A Fiduciary argument against Stakeholder Theory” (2003) 13 *Business Ethics Quarterly* 1.

employees do not have share the same vulnerability, which lacks the moral basis for fiduciary duties. The information that employees need is more about the employment relationship, and this information can be observed because employees are more aware of managers' performance on the employment contract. In addition, they have the discretion to reduce or withdraw their human capital investments in the firm at any time because the amount they invest cannot be specified in their contract. In this case, directors' relationship with employees is not morally significant. Hence, uniform fiduciary duties to all stakeholders will damage the shareholders' moral claims on directors.

A more recent argument states that stakeholders' interests should be in harmony, and therefore the stakeholders' interests should be considered as a whole,²⁰⁹ which parallels the team production theory. Similarly, it is a challenge for directors to balance interests among different stakeholders and they become vulnerable to the "two masters problem".

This thesis does not aim to refine or develop this theory. Despite the theoretical as well as practical difficulties, stakeholder theory provides insights by identifying the deficiencies of shareholder primacy and arguing for a stakeholder-oriented corporate management model. This also complies with the mindset of managers, since "the vast majority of them apparently adhere in practice to one of the central tenets of stakeholder theory, namely, that their role is to satisfy a wider set of stakeholders, not simply the share owners".²¹⁰

In conclusion, both ESV and stakeholder theories highlight the value of stakeholders, including employees, to the firm, which evidences the trend for a less shareholder-oriented approach in corporate governance. In addition, after examining the practical difficulties of these stakeholder-oriented models, it is evident that without a

²⁰⁹ R. Phillips, R. E. Freeman and A. C. Wicks, "What Stakeholder Theory is Not" (2003) 13 *Business Ethics Quarterly* 479.

²¹⁰ T. Donaldson and L.E. Preston, "The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications" in M.B.E. Clarkson (ed), *the Corporation and Its Stakeholder* (n 188) 184.

mechanism to involve employees' claims in takeover decision-making, they will experience challenges in having their interests effectively considered by directors.

2.1.4 German Firms' Approaches to Corporate Governance

The three corporate governance models provide an insight regarding the inclusion of stakeholders' claims in the mindsets of company directors, as well as regarding practical difficulties. As this thesis attempts to introduce the German mechanism in order to overcome problems in China, it is necessary to examine the German approaches to corporate governance. In order to achieve this objective, scholars have provided different models, which are analysed as follows.

The German Variant of Stakeholder Theory

Some stakeholder theorists perceive the German corporate governance model as a variant of stakeholder theory,²¹¹ especially considering the extensive influences of workers on corporate decision making. However, the development of stakeholder approaches in Germany is independent from the literature in the US, where the idea of stakeholder theory originates.²¹² In other words, although it is generally agreed that stakeholders, especially employees, can actively participate in corporate management, the German variation of stakeholder approaches shows a distinct pattern.

First, according to the American stakeholder approach, all groups of stakeholders have intrinsic value and therefore should be cared for by directors. However, in German companies, in addition to shareholders, the interests of two groups of stakeholders are particularly considered by the management, namely creditors and employees.²¹³ This arises from the unique economic and historical contexts in Germany, which are examined in detail in Chapters 4 and 5. Briefly speaking, the emphasis on creditors'

²¹¹ U. Hansen, M. Bode, and D. Moosmayer, "Stakeholder Theory between General and Contextual Approaches- A German View" (2004) 5 *Zfwi Zeitschrift für Wirtschafts-und Unternehmensethik* 242.

²¹² R.E. Freeman, "The Stakeholder Approach Revisited" (2004) 5 *Zeitschrift für Wirtschafts-und Unternehmensethik* 228.

²¹³ S. Vitols, "Negotiated Shareholder Value: the German Variant of an Anglo-American Practice" (2004) 8 *Competition & Change* 357.

interests arises from the bank-dominated economy, where banks have a decisive say over the funding of the company. The strong labour rights came from the entrenched spirit of social democracy and long history of unionism.

Second, different from the US model which leaves the balancing of the interests of different groups of stakeholders up to the discretion of the corporate leadership, German companies have established an effective scheme for employees to safeguard their rights and participate in corporate governance, which is referred to as the co-determination mechanism. (Details of the mechanism can be found in Chapter 5.) This arises from the differences in corporate structures between German firms and those in the US. To be specific, directors in the former do not have as strong authority as those in the latter in terms corporate governance.

To sum up, the German corporate governance model is stakeholder oriented, compared to models based in shareholder primacy, since certain stakeholders have the ability to influence corporate decision-making, echoing some key arguments of stakeholder theory. Accordingly, it is reasonable that some scholars deem the German model as a variant of stakeholder theory. However, stakeholder approaches in Germany are developed in distinct contexts from those in the American tradition, and therefore, the German model cannot be accurately and fully explained by stakeholder theory. In this regard, several theories are provided to explain the German approach to corporate governance.

The Collective Voice Model

This model is used to explain the ideology underlying the German co-determination mechanism,²¹⁴ with an emphasis on the relationship between the employer and employees internal to the company. The collective voice model is based on three key factors underlying the German context.

²¹⁴ J.T. Addison, *The Economics of Codetermination: Lessons from the German Experience* (Palgrave Macmillan 2004) 27.

The first is the incompleteness of the contract, which has been discussed in Section 2.1. Incomplete contracts are expected to lead to problems for both employers and employees. Therefore, a mechanism is needed to address the problems for both sides. For employers, they need to avoid employees' withholding their effort input on the job, which will be discussed in Section 2.2.2. In the meantime, workers need solutions for when they are treated below their expectations and when their needs are not met. In general, under this circumstance, workers have the option to quit their jobs and seek better employment. However, due to the low mobility of the German labour market (details of which can be found in Chapter 4), workers are more likely to engage with their voices, especially when they are collectively represented by a workers' representation mechanism. This can be deemed "a victory for workers who no longer need to rely on implicit contracting to secure essential benefits in the workplace."²¹⁵

Second, collective voices can more effectively and accurately expressed than the voice of each individual. Accordingly, workers are organised to express their claims, giving strong voices in the company. To be specific, via the worker representation system, workers have more incentives to reveal their preferences. This is because "action of the part of others may produce the public good at no cost to that individual."²¹⁶ In this way, collective and unbiased voices that can reflect workers' general opinions are formed, making the expression more efficient and effective. Undoubtedly, the collective voices are expected to increase costs in labour management, which forces management to save costs elsewhere.²¹⁷ However, this system can also improve workers' effort inputs on the job, which would counteract increased labour costs.²¹⁸

Third, the effectiveness of the model hinges on how management responds to the workers' collective voices. The positive effects of these voices can be thwarted by managements' unfavourable response. In other words, management should make adjustments in response to workers' collective claims to make the latter a positive force

²¹⁵ C. Hogan, "Enforcement of Implicit Employment Contracts through Unionization" (2002) 19 *Journal of Labor Economics* 171.

²¹⁶ J. T Addison, *The Economics of Codetermination* (n 213) 31.

²¹⁷ R.B. Freeman and J.L. Medoff, "The Two Faces of Unionism" (1979) 57 *Public Interests* 69.

²¹⁸ A. Bryson, "Unionism and Workplace Closure in Britain, 1990-1998" (2004) 42 *British Journal of Industrial Relations* 283.

to make the firm prosper in the long run.²¹⁹ Therefore, the relationship between the employer and employees is perceived as a partnership rather than opposition, with an emphasis on settling conflicts peacefully and cooperatively.

The collective voice model provides insights in how workers are organised and treated by corporate management. In other words, it reflects an ideology of workers' participation in corporate management. However, this model does not identify the stakeholder relationship, especially the role of shareholders in German firms. Accordingly, the negotiated shareholder value model is suggested to explain the German approach.

The Negotiated Shareholder Value Model

As discussed above, the German corporate governance model is traditionally perceived as the stakeholder model. However, starting in the 1990s, German companies witnessed a fundamental change from a stakeholder-oriented to a shareholder-oriented corporate governance model.²²⁰ This can be evidenced by the gradual adoption of shareholder value by German managers and the introduction of investor relations departments in most large German corporations. At the same time, employees could still exert substantive influence over corporate decisions through the co-determination mechanism. In other words, employees' role in German firms remained stable against the more shareholder-oriented approach.²²¹ In this context, the negotiated shareholder value model²²² is suggested to describe this change in managerial mindset.

Compared to the traditional German corporate governance model, the negotiated shareholder value model integrates shareholders, especially institutional shareholders, into a stakeholder coalition. Accordingly, shareholder value should be taken into account in corporate governance. However, the German variant of shareholder value

²¹⁹ R.B. Freeman and J.L. Medoff, *What Do Unions Do?* (Basic Books- 1984) 165.

²²⁰ M. Bradley and A.K. Sundaram, "The Emergence of Shareholder Value in the German Corporation" (2003) *EFA 2004 Maastricht Meetings Paper No.1467*.

²²¹ M. Hopner, "Corporate Governance in Transition: Ten Empirical Findings on Shareholder Value and Industrial Relations in Germany" (2001) *Max-Planck-Institute for the Study of Societies Working Paper No.05/2001*.

²²² Vitols (n 213).

shows distinct features of shareholder primacy, which is entrenched in the Anglo-American tradition. Since shareholders and stakeholders, especially employees, work in cooperation, a compromise needs to be reached, which may change the nature of the demands of shareholder value.

Based on the description of the negotiated shareholder value, whether the shareholders' interests are prioritised in German companies is subject to negotiations and compromises between stakeholders. In this regard, although this model identifies the increasing role of shareholders, German firms can still be deemed to adopt stakeholder-oriented approaches, especially considering the stability of the co-determination mechanism in German companies.

Against the background of German firms' adoption of a more shareholder-oriented approach, there are scholars who argue that the co-determination mechanism in German firms should be weakened or even abandoned.²²³ However, this thesis does not agree with this argument, especially considering the pivotal role of the co-determination mechanism in implementing the social policies of Germany, which is one of the most renowned welfare states.

German Approaches to Corporate Governance and the Welfare State

As one of the most renowned welfare states, Germany pays particular attention to safeguarding workers' rights. This is not only because of the German history of valuing workers' basic rights (see Section 5.3.2), but it is also due to their contributions to the German welfare system, which generally has two aspects.

First, workers' participation in corporate decision making brings considerations of social policy to corporate policies, which benefits the public welfare. This is especially the case considering workers' pivotal role in implementing social democracy and developing the German economy. By establishing the co-determination mechanism,

²²³ W. Streeck and C. Trampusch, "Economic Reform and the Political Economy of the German Welfare State" (2005) 14 *German Politics* 174.

the state spreads the responsibility for the public welfare and social and economic prosperity. According to the view of German courts, the workers' representation and participation mechanism "transcended the mere representation of workers in corporate decision-making processes."²²⁴ It does not only serve the interests of workers. Rather, it is appropriate for politically securing the German market economy, which serves the general public.

Second, the German worker representation mechanism is used as an adjustment device for implementing social policies, especially to help maintain social harmony and stability. Since in Germany, the collective bargaining between employers and employees is independent of state intervention, which is referred to as the principle of *Tarifautonomie*, the co-determination mechanism is decisive in implementing social policies promoting welfare through industrial relations.²²⁵ Accordingly, guided by the state, a compromise between employees and employers is reached. To be specific, workers accept the free market system and the management of entrepreneurs whilst the latter accept the worker representation mechanism as well as social policies to safeguard workers' interests.²²⁶ This mechanism provides a stable institutional framework to resolve conflicts between employees and employers, and through frequent interactions and negotiations, these conflicts can be addressed flexibly.

As can be seen above, the workers' participation in corporate governance arises from the state's need to implement social policies, especially considering that Germany is a well-known welfare state. That is to say, beyond the mere economic consideration, the entrenchment of the co-determination system in German companies is also out of political considerations. Therefore, the value of shareholders' interests has increased, but the existing model with a co-determination system and consideration of workers' needs is still too resilient to allow this new valuation of shareholder interests to change the governance model much.

²²⁴ F. Behling, *Welfare Beyond the Welfare State: The Employment Relationship in Britain and Germany* (Palgrave Macmillan-2018) 127.

²²⁵ C. Trampusch, "Industrial Relations and Welfare States: The Different Dynamics of Retrenchment in Germany and the Netherlands" (2006) 16 *Journal of European Social Policy* 121.

²²⁶ F. Kaufmann, *Variations of the Welfare State* (Springer-2013) 47.

In conclusion, the German approaches to corporate governance share certain similarities with stakeholder theory. However, since the German system is embedded in social, economic, and political contexts that are distinct from those in the American tradition, the landscape of corporate governance in German firms has its own features. In summary, although there is a trend showing that shareholder value is becoming more widely adopted in Germany, the entrenchment of the co-determination mechanism ensures that German companies continue using a stakeholder approach, with an emphasis on workers' participation rights in corporate governance.

2.1.5 Conclusion

This section has examined the challenges to shareholder primacy as well as to stakeholder-oriented corporate governance models opposed to the former. To be specific, prioritising shareholders' interests whilst neglecting other stakeholders' claims is far from optimal when measured against standards of business ethics. The evidence also shows that it is not conducive to firm value. In addition, theories of the firm that support shareholder primacy can also explain the connection of other stakeholders to the firm. As to the property rights theory, the use of property rights should be moral and not harm other stakeholders. Besides, constituents such as employees can also be deemed to own the firm. From the perspective of the nexus-of-contract theory, the relationship of employees with the firm is more than contractual, because the contracts can never be complete. Otherwise, they can also be perceived as residual claimants due to their firm-specific investments. In this context, the incomplete contract theory can perhaps better explain stakeholders' relationship with the firm, which leads to other stakeholder-oriented corporate governance models.

The first is enlightened shareholder value that has been adopted by the UK, which is a modification of shareholder primacy. It emphasises the firm's long-term rather than short-term interests. Accordingly, other constituents' claims should be valued by directors since this aligns with shareholders' long-term interests. However, due to the lack of an effective enforcement mechanism, directors' duties to employees remains a "law in the book". The second is team production theory, which is more revolutionary.

It describes a public corporation as a team of members who make specific investments in the firm. Directors who have supremacy in corporate management act as mediators if there are conflicts among team members. This theory deems directors as trustees of the firm, who engage in improving firm value. However, it has limitations in describing firms of different types while also leading to the “two masters problem”. The third is stakeholder theory, which holds that stakeholders have intrinsic value that merits consideration, which is not subordinate to shareholder value. However, this theory lacks feasibility in practice because directors being accountable to all stakeholders would mean that in fact, they are accountable to none. With regard to employees, there is no agreement on their relationship with the firm and the directors. At the end of this section, the corporate governance model of German firms was examined. Stakeholders in German firms, especially employees, are able to exert substantial influence over corporate decision-making, making the model similar to stakeholder theory. However, due to the unique economic, social, and political background, the German system shows its own characteristics. In brief, the worker representation mechanism expresses workers’ collective voices and maintains a friendly partnership with employers. This relationship can hardly be altered in the foreseeable future, despite the fact that shareholders’ interests are becoming more valued by German firms.

Challenges to shareholder primacy and the rise of other corporate governance models show a change in directors’ mindset from serving shareholders exclusively to caring about other stakeholders’ interests as well. On the other hand, all these shareholder-oriented models lack practicability. One of the common drawbacks is the “two master problem”, making it a challenge for directors to weigh the value of different groups of stakeholders. Indeed, it should not be solely at the discretion of directors to balance the claims from different constituents. Taking employees, for example, an effective mechanism should be established to express their voices to shareholders, which impedes directors’ expropriation of other stakeholders’ interests for their own benefits.

In order to maximise shareholders’ interests in the long run, employees’ claims also should be valued by management. Stakeholder theorists argue that the interests of

different stakeholder groups should be considered as a whole, and therefore employees' interests should not be subordinated to shareholders' interests. These theories reflect a transformation from shareholder-oriented models to stakeholder-oriented models, which suggest that management should pay attention to employees' claims.

From an examination of the practical difficulties of these stakeholder-oriented theories, it is clear that employees' interests cannot be left entirely to the discretion of the management. Instead, an effective employees' participation mechanism should be established to ensure that employees' views are expressed and valued. The German model of corporate governance provides such an effective mechanism.

2.2 Economic Grounds for Enhanced Employee Participation in Hostile Takeovers

Having identified a sound theoretical foundation for the enhanced involvement of employees in takeovers, this section moves on to explore the economic grounds for doing so, with the objective of proving that deeper labour participation positively affects firm value.

One of the major concerns about the enhancement of labour protection in the context of hostile takeovers is its potential negative impact. In particular, there are scholars who argue that a major improvement in the level of labour protection will lead to the reduction in takeover activities and the removal of any consequent economic gains to both acquirers and target firms.²²⁷ This argument is plausible, since enhancing workers' bargaining power is expected to raise compensation in layoffs, and accordingly increase the costs of a takeover and the subsequent restructuring. On the other hand, it should be noted that employees tend to resist takeovers that may hurt the firms' long-term interests,²²⁸ while the treatment of workers is one of the key determinants of the

²²⁷ O. Dessaint, A. Golubov, and P. Volpin, "Employment Protection and Takeovers" (2017) 125 *Journal of Financial Economics* 369.

²²⁸ In a takeover in Shanxi, China, in 1998, workers of the target corporation protested against the takeover because they were aware of the fact that the acquirer "was actually only interested in the factory estate for resale rather than for production." This damaged the long-term interests of the firm as well as themselves". See: F. Chen,

success of a takeover.²²⁹ Conceivably, a moderate level of employee protection and involvement aligns with a firm's economic interests, being reflected mainly in three aspects. First, it helps to improve workers' productivity, which is conducive to firm value. Second, it mitigates risks of employers' holding up employees' firm-specific investments when faced with hostile takeovers. Third, given a higher level of employee supervision over management in takeovers, shareholder–management costs are expected to reduce. These three aspects are analysed below.

2.2.1 Positive Correlation of Employee Involvement with Productivity and Firm Performance

Empirical studies show that employee involvement correlates positively to firm productivity.²³⁰ According to the incomplete contract theory, which holds that employees' relationship with firms cannot be fully contracted, how much effort employees should provide on their job cannot be specified in advance in explicit contracts.²³¹ Therefore, one of the key objectives for employers is to encourage and maximise their efforts in order to improve productivity. This thesis holds that employees' participation in corporate management can help achieve these objectives, since it relates positively to employees' job satisfaction, job commitment, and accordingly productivity.²³² Empirical studies also support the positive correlation of employees' participation with firm performance. This subsection describes these aspects step by step, to identify how an employee participatory management mechanism can positively affect firm value.

Job satisfaction is defined as “a pleasure or positive emotional state resulting from the appraisal of one's job or job experience”.²³³ In general, firms offering a higher degree

“Industrial Restructuring and Workers' Resistance in China” (2003) 29 *Modern China* 237.

²²⁹ J.E. Gutknecht and J.B. Keys, “Mergers, Acquisitions and Takeovers: Maintaining Morale of Survivors and Protecting Employees” (1993) 7 *The Academy of Management Executive* 26.

²³⁰ E. Wolf and T. Zwick, “Reassessing the Productivity Impact of Employee Involvement and Financial Incentives” (2008) 60 *Schmalenbach Business Review* 160.

²³¹ R.E. Kidwell and N. Bennett, “Employee Propensity to Withhold Effort: A Conceptual Model to Intersect Three Avenues of Research” (1993) 18 *Academy of Management Review* 429.

²³² P. Böckerman and L. Pekka “The Job Satisfaction-productivity Nexus: A Study Using Matched Survey and Register Data”(2012) 65 *ILR Review* 244.

²³³ E.A. Locke, “The Nature and Causes of Job Satisfaction” in M.D. Dunnette (ed), *Handbook of Industrial and Organizational Psychology* (Rand McNally & Co-1976) 1293.

of job satisfaction are more likely to thrive and prosper.²³⁴ There are empirical studies showing that “the effect of an increase in the establishment’s average level of employee job satisfaction on productivity is positive”.²³⁵ However, this correlation is stronger in manufacturing industries than non-manufacturing industries. This difference can be explained especially by considering job satisfaction as just one determinant of productivity. The productivity of non-manufacturing industries is affected by factors such as customer policies and market demand in addition to job satisfaction, whereas for manufacturing industries productivity is largely determined by the workers’ efforts. Whether workers are willing to put greater effort into their jobs depends mainly on their satisfaction. In addition, not all dimensions of job satisfaction can motivate workers to improve their productivity. According to the two factor theory model formulated by Frederick Herzberg,²³⁶ there are two dimensions to job satisfaction, which consist of motivating and hygiene factors. Only the former can improve employees’ motivation to work, while the latter refers to those factors whose absence makes workers less industrious. However, labour empowerment is deemed a motivating factor, and employee participation can boost workers’ satisfaction, accordingly, improving their productivity. In the context of takeovers, unjust treatment arising from a change of management is expected to increase employees’ job anxiety. For fear of losing their jobs or a change in work conditions or policies, levels of job satisfaction are expected to decrease due to the absence of job security, which is a hygiene factor according to the Two Factor Theory Model. Such anxiety accumulated over time leads to workers’ difficulty in coping with job demands and inhibits workers’ new learning in their jobs. In this context, when workers’ future is unpredictable, a mechanism that facilitates information sharing and employees’ participation can help to alleviate this job anxiety. This can counteract the negative impact of potential takeovers on firms’ productivity.²³⁷

²³⁴ M. Altman, *Worker Satisfaction and Economic Performance: Microfoundations of Success and Failure* (ME Sharpe-2001) 9.

²³⁵ P. Böckerman, P. Ilmakunnas, “The Job Satisfaction-productivity Nexus: A Study Using Matched Survey and Register Data (2012) 65 *Industrial and Labor Relations Review* 244.

²³⁶ H. Frederick, M. Bernard, and S. Barbara, *The Motivation to Work* (John Wiley-1959).

²³⁷ C. Ostroff, “The Relationship between Satisfaction, Attitudes, and Performance: An Organizational Level Analysis” (1992) 77 *Journal of Applied Psychology* 963.

Job commitment refers to “the relative strength of an individual's identification with and involvement in a particular organization”.²³⁸ Factors of job commitment include: (1) the alignment of individual values with the values and objectives of the firm; (2) workers’ willingness to put in considerable effort for the organisation; (3) workers’ desire to maintain a long-term relationship with the firm.²³⁹ Unlike job satisfaction, which is an attitude towards certain aspects of a job,²⁴⁰ job commitment emphasises a workers’ bond with the firm, and accordingly the latter is deemed a better predictor of productivity than job satisfaction.²⁴¹ Empirical studies evidence the positive correlation between employees’ deeper participation and job commitment²⁴² as well as between job commitment and productivity.²⁴³ This is reasonable, since workers’ involvement in corporate decisions is expected to bond workers closely with the firm, and accordingly they tend to care more about the firm’s long-term value. In this case, they have more incentive to make firm-specific investments, such as investing time and effort to improve their firm-specific skills, which positively affects their efficiency as well as productivity. Empirical studies illustrate that with stronger job commitment workers are more likely to be innovative at work²⁴⁴ and exhibit a greater willingness to make concessions, such as working overtime voluntarily, which may increase the enterprise’s investment in capital.²⁴⁵ Another consequence is that workers become more open to engaging in positive discretionary behaviour, such as providing assistance to colleagues, adhering to specific rules, and making suggestions to improve effectiveness.²⁴⁶ To sum up, stronger job commitment is expected to improve workers’

²³⁸ R.M. Steers, “Antecedents and Outcomes of Organization Commitment” (1977) 22 *Administrative Science Quarterly* 46.

²³⁹ N.J. Allen and J.P. Meyer, “Affective, Continuance and Normative Commitment to the Organization: An Examination of Construct Validity” (1996) 49 *Journal of Vocational Behavior* 252.

²⁴⁰ Y. Wiener, “Commitment in Organizations: A Normative View” (1982) 7 *The Academy of Management Review* 418.

²⁴¹ J.L. Koch and R.M. Steers, “Job Attachment, Satisfaction, and Turnover among Public Employees” (1978) 12 *Journal of Vocational Behavior* 119.

²⁴² K.K. Bhatti and T.M. Qureshi, “Impact of Employee Participation on Job Satisfaction, Employee Commitment and Employee Productivity” (2007) 3 *International Review of Business Research Papers* 54.

²⁴³ J.H. Westover, A.R. Westover, and L.A. Westover, “Enhancing Long-term Worker Productivity and Performance: The Connection of Key Work Domains to Job Satisfaction and Organizational Commitment” (2010) 59 *International Journal of Productivity and Performance Management* 372.

²⁴⁴ K. Kraft, J. Stank, and R. Dewenter, “Co-determination and Innovation” (2009) 35 *Cambridge Journal of Economics* 145.

²⁴⁵ R.B. Freeman and E.P. Lazear, “An Economic Analysis of Works Councils” (1994) (No. w4918) *National Bureau of Economic Research* available at <https://www.nber.org/papers/w4918.pdf>.

²⁴⁶ P. Warr, “Well-being and the Workplace” in D. Kahneman, E. Diener, and N. Schwartz (eds), *Well-Being: The Foundations of Hedonic Psychology* (Russel Sage Foundation-1999) 404.

willingness to put effort into their jobs, and accordingly to improve productivity. If workers are endowed with information and participation rights in the context of takeovers, when workers are particularly vulnerable to unjust treatment, they are expected to have stronger job commitment, which positively affects the firm's productivity.

In conclusion, establishing an employee participatory mechanism in the context of hostile takeovers has a positive impact on job satisfaction and job commitment, which improves firms' productivity. However, despite the increased productivity, a stronger employee protection and participation mechanism can be a double-edged sword. This is because this mechanism has been witnessed to enhance the bargaining power of employees,²⁴⁷ which in turn encourages their rent-seeking behaviour. This normally results in higher wages and costly labour welfare programmes at the expense of the firm's profits. Workers fighting for their interests may force shareholders to settle for a smaller slice of the pie of firm value, although the increase in workers' productivity increases the overall size of the pie. Given this scenario, arguments that stronger labour protection does have negative²⁴⁸ or neutralising²⁴⁹ effects on the economic performance of firms are equally valid, as explained below.

The dominance of any stakeholder group will lead to an expropriation of resources or assets from other groups. Accordingly, excessive labour costs arising from workers' increasing bargaining powers are naturally detrimental to firm and shareholder value. However, if increased productivity can compensate for the rising labour costs, it is a mechanism worth introducing. As identified by previous studies, workers' participation in decision-making (which is measured by employees' representation on the board) and firm value form an inversely U-shaped relationship. To be specific, "The prudent use of labour in corporate governance can be value enhancing. Excessive

²⁴⁷ K. Kraft, "Productivity and Distribution Effects of Co-determination in an Efficient Bargaining Model" (2018) 59 *International Journal of Industrial Organization* 458.

²⁴⁸ G. Gorton and F.A. Schmid, "Capital, Labor, and the Firm: A Study of German Co-determination" (2004) 2 *Journal of the European Economic Association* 863. See also O. Bohren and R.O. Storm, "Governance and Politics: Regulating Independence and Diversity in the Board Room" (2010) 37 *Journal of Business Finance & Accounting* 1281.

²⁴⁹ E. Ginglinger, W. Megginson, and T. Waxin, "Employee Ownership, Board Representation, and Corporate Financial Policies" (2011) 17 *Journal of Corporate Finance* 868.

influence of labour, on the other hand, may create a firm that is a ‘country club’ for workers”.²⁵⁰ This can explain why studies repudiate the advantages of labour protection and intervention. Although this is based on statistics collected from Germany, Chinese firms are expected to follow a similar pattern. Accordingly, if workers’ involvement remains at a moderate level, the increased productivity can compensate for the costs arising from workers’ participation, which means the mechanisms prioritising employee participation in corporate decision-making are worth introducing. Unlike German companies, which are renowned for strong employee empowerment, Chinese workers have no effective channel to raise their voice with management. Hence, as long as workers’ involvement does not exceed a moderate level, establishing a workers’ participation mechanism is expected to be value enhancing. It should, however, be noted that no uniform optimal level of workers’ participation that can maximise firm value can be applied to all companies. The appropriate level of employee participation may vary depending on the industry and on the specific conditions of a firm, which need to be explored on a case-by-case basis in practice.

2.2.2 Employee Participation to Forestall Hold-up Problems

Hold-up problems are central to the incomplete contract paradigm; they refer to a situation in which two parties to a contract may be in a position to work efficiently but choose to refrain from doing so due to the incompleteness of the contract.²⁵¹ Hold-up problems can occur when two features are present.²⁵² The first is that the parties to the contract have made investments prior to the transaction. This can be deemed as the preparation for the performance of the contract. The second feature is that the optimal level of investments cannot explicitly be specified in the contracts. Both these features are found in an employment relationship.

²⁵⁰ L. Fauver and M.E. Fuerst, “Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards” (2006) 82 *Journal of Financial Economics* 673.

²⁵¹ B. Klein, R.G. Crawford, and A.A. Alchian, “Vertical Integration, Appropriable Rents, and the Competitive Contracting Process” (1978) 21 *The Journal of Law and Economics* 297.

²⁵² W.P. Rogerson, “Contractual Solutions to the Hold-Up Problem” (1992) 59 *The Review of Economic Studies* 777.

With regard to the first feature of prior investments, both the employer and employees are expected to invest their resources, time, and effort. For instance, workers may move to apartments nearby the workplace for convenience. They may also engage in improving their firm-specific skills, while the employer may invest money and resources to training them. The costs of these investments are sunk²⁵³ in performing the employment contract. Unlike other contracts where transactions are made on an equal footing, employees and the employer are bound together in a subordination relationship,²⁵⁴ subjecting employees to the orders and regulations made by the employer. Therefore, employees are exposed to risks of being held up by the employer.

Regarding the second feature, details of employee behaviours cannot be contracted,²⁵⁵ and they accordingly have the discretion to decide on the efforts that they are willing to make on the job. Therefore, they tend to withhold their firm-specific investments in performing the employment contract. Admittedly, employers may have a supervision system that aims to discipline workers if they shirk responsibilities, such as in case of absenteeism. However, the gap between employees obeying the work policies and regulations and their maximising efforts on their job is significant, mainly because the optimal levels of employees' investments cannot be agreed upon by the employer and employees beforehand. Therefore, when confronted with any uncertainty about the employer's willingness to invest in the employment relationship or tendency to expropriate employees' gross gains in performing the employment contract, employees tend to withhold their first specific investments.

As examined in Chapter 1, takeovers expose employees to the risks of a breach of implicit employment contracts and the employer's expropriation of their rents. Therefore, when a takeover is anticipated, due to the asymmetry of information between employees and management and the predicted dramatic change in the firm, the future position of the employees after a takeover is outside the scope of their existing contract with the employer.²⁵⁶ Given their low bargaining power to seek fair

²⁵³ Sunk cost refers to the costs that have already been made but cannot be recovered in a transaction.

²⁵⁴ D. Cabrelli, *Employment Law in Context: Text and Materials* (Oxford University Press-2014) 68.

²⁵⁵ M.V.K. Belot, J. Boone and J.C. Van Ours, "Welfare Improving Employment Protection" (2007) 74 *Economica* 381.

²⁵⁶ B. Klein, "Why Hold-ups Occur: The Self-enforcing Range of Contractual Relationships" (1996) 34 *Economic*

treatment,²⁵⁷ then in order to reduce their costs, employees become reluctant to invest further, since their underinvestment cannot be recognised by the employer or the court. Such reluctance is stronger when employees have accepted low wages in the hope of a long-term employment relationship and above-market wages in the future, making them more likely to withhold their investments towards their employer when confronted by takeovers. In the contractual relationship, the employer can hardly be expected to gain sufficient returns from their investments, even though they may invest in vocational training or develop an incentive mechanism.

The hold-up problems in the context of takeovers adversely affect the value of the target firm, since they lead to a reduction in productivity, especially considering that most hostile takeovers may take several years. For target firms, the decrease in firm value may lead to a decline in their attractiveness to corporate raiders, and accordingly incumbent shareholders may obtain a lower price premium. The decrease in firm value also reduces the likelihood of a value increasing takeover.²⁵⁸ This is because in takeovers, as mentioned above, shareholders are deemed to expropriate rents from employees. On the other hand, employees may restrict their productive efforts to forestall potential takeovers, so that the acquirers have less to expropriate. Therefore, they may end up expropriating only a fraction of the increase in firm value. In the event that the hostile takeover is successful, workers who withhold their investments may be undervalued by the new management, and accordingly they may receive worse treatment than expected, even extending to job loss or wage cuts.

The hold-up problems can be effectively addressed if the information is complete, while both employees and employers have the capability to know the efforts which the other party is putting into their jobs. In this case, all the contingencies can be foreseen, and therefore there will be no hold-up problem.²⁵⁹ In this regard, it is necessary to establish a mechanism to improve employee involvement in the context of takeovers.

Inquiry 444.

²⁵⁷ P. Fulghieri and M. Sevilir, "Mergers, Spinoffs, and Employee Incentives" (2011) 24 *The Review of Financial Studies* 2207.

²⁵⁸ G. Ghemla, "Hold-up Stakeholders and Takeovers Threats" (2005) 14 *Journal of Financial Intermediation* 376.

²⁵⁹ B.E. Kaufman and D.G. Taras, *Nonunion Employee Representation: History, Contemporary Practice, and Policy* (M.E. Sharpe-2000) 150.

For one thing, this promotes information flow, which for employees reduces the uncertainty about their treatment following a takeover. For another, it provides employees with an opportunity to participate in takeover decisions, which strengthens workers' bonds with the firm, thereby mitigating the likelihood of employees withholding their firm-specific investments. Deeper involvement is normally accompanied by a positive level of employee protection, which is deemed to be effective in overcoming hold-up problems.²⁶⁰

2.2.3 Reducing Agency Costs

Almost any contractual relationship in which one party (the “agent”) promises to undertake performance of services to another party (the “principal”) is subject to a principal–agent problem. Agency costs arise due to the conflict of interests between the principal and the agent. In general, three generic agency problems arise in business firms.²⁶¹ The first agency relationship issue exists between shareholders and hired managers. The second involves the conflict between majority and minority shareholders. The third agency problem arises from firm owners' opportunistic behaviour towards parties (including employees) contracting with firms. From the perspective of economists, employee involvement in takeover decisions can address the first and third problems.

In this context, these two sets of agency relationships are discussed: the first arises from the shareholder–management nexus, which is the core agency relationship in corporate governance, wherein employees are empowered to perform the supervision function, which helps to reduce agency costs. We analyse below how workers' participation can reduce these two sets of costs. The second is between the employer and its employees. In the employment relationship, workers have a propensity to withhold efforts, leading to agency costs. Workers' involvement in takeover decisions can reduce such costs, making them more willing to increase their efforts on the job. In this section, the first core agency relationship is firstly discussed.

²⁶⁰ B. Michele, J. Boone, and J. Van Ours, “Welfare-Improving Employment Protection” (2007) 74 *Economica* 381.

²⁶¹ R. Kraakman, P. Davies, J. Armour, H.B. Hansmann, G. Hertig, L. Enriques and K.J. Hopt, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press-2017) 35.

Shareholder–Manager Agency Relationship

The shareholder–manager relationship constitutes the core principal–agent relationship in business firms. The shareholders, acting as either the owner of the property of the firm under the property rights theory or the residual claimants under the nexus-of-contract theory, “have surrendered the right that the corporation should be operated in their sole interest”²⁶² to managers. Managers, with distinct interests from the shareholders, may engage in forms of behaviour that reduce or destroy the maximisation of firm value, such as shirking,²⁶³ self-dealing,²⁶⁴ or seeking high management remuneration or business opportunities. These opportunistic behaviours mainly arise from the managers’ authority over corporate management as well as the employees. Such authority relations “generate the structural preconditions under which employer opportunism is most likely to be encouraged; namely, information impactedness, small numbers, and availability of a tool (decision by fiat) which is tailor-made for unilateral pursuit of self-interest”.²⁶⁵ To be specific, managers are normally reluctant to provide optimal information, considering that all pieces of information are transmitted to management. This is because “bargaining power is generally correlated with information, [and] centralization of information, [which] without access to it when necessary, can lead to its hoarding and misuse”.²⁶⁶ Therefore, managers may have an incentive to withhold some information to achieve better salaries and promotion. Employee involvement can facilitate the sharing of information, which constrains managers’ opportunistic behaviours. However, this may compromise the efficiency of management decisions, since the centralisation of information on which decisions are based makes for greater efficiency.²⁶⁷ In this regard, promoting information sharing between employees and management is the

²⁶² Berle & Means, *The Modern Corporation* (n 88) 355.

²⁶³ Shirking refers to the phenomenon that the directors shirk the responsibilities to maximise the shareholder value with optimum efforts. See Kershaw, *Company Law in Context* (n 59) 179.

²⁶⁴ Self-dealing refers to the fact that the directors enter into a transaction with the company that benefit themselves at the expense of the company. See Kershaw, *Company Law in Context* (n 59) 179.

²⁶⁵ G. Dow, “The Function of Authority in Transaction Cost Economics” (1987) 8 *Journal of Economic Behavior and Organization* 13.

²⁶⁶ S.C. Smith, “On the Economic Rational for Co-determination Law” (1991) 16 *Journal of Economic Behavior and Organization* 261 at 265.

²⁶⁷ K.J. Arrow, *The Limits of Organization* (Norton-1974) 674.

second-best option, but can prevent managerial opportunistic behaviour which may hurt the interests of the firm. In addition, managers' opportunistic behaviour may hinder employees' innovation, which negatively affects shareholders' interests. This is because managers have a strong incentive to make it seem that the innovative ideas originate from them rather than the employees. Hence, they may take credit for employees' innovations so as to justify their high salaries and promotions.²⁶⁸ In this regard, productive workers tend to serve managers' private interests, which limits the scope for workers to be motivated to engage in innovative practices. This lowers the profits for shareholders as well as the remuneration of employees, as the latter's innovative ideas are not recognised by their superiors. Such opportunistic behaviour can also be eliminated through employees' cooperation with managers. Admittedly, reverse monitoring of managers cannot solve managerial opportunism fully, due to the significant leeway they enjoy and the costs to efficiency. However, an employee involvement scheme can provide a useful addition to the current corporate governance system.

In hostile takeovers, target firms, normally with dispersed shareholding structures, are subject to informational asymmetries, collective action problems,²⁶⁹ and shareholder myopia.²⁷⁰ Therefore, shareholders do not have "the information or incentives necessary to make sound decisions"²⁷¹ to maximise their interests as well as the firm value. As a result, managers may take advantage of insider information and advanced managerial capability, which leads to the higher incidence of opportunistic behaviour.²⁷² For instance, in order to frustrate takeovers, managers may resort to value reduction strategies such as selling valuable assets or divisions at a discounted price (referred to as "the sale of the crown jewels"), which lowers the attractiveness of target firms. This normally leads to a decrease in a firm's valuation, which lowers

²⁶⁸ Smith (n 266) at 265.

²⁶⁹ Collective action problems refer to the phenomenon that different shareholders have different information and incentives, and therefore have difficulties in reaching a general agreement.

²⁷⁰ Shareholder myopia means that investors in the public corporation may focus on short-term returns rather than long-term returns, and therefore when faced with takeovers, the shareholders may sell their shares at a price below their actual value. See Stein (n 58).

²⁷¹ S. M. Bainbridge. "Director Primacy: The Means and Ends of Corporate Governance" (2002) No. 02-06 *University of California, Los Angeles School of Law Research Paper Series* 21.

²⁷² L. Dann and H. DeAngelo, "Corporate Financial Policy and Corporate Control: A Study of Defensive Adjustments in Asset and Ownership Structure" (1988) 20 *Journal of Financial Economics* 87.

share prices if takeovers are frustrated, whereas target firm shareholders' returns from takeovers are reduced if takeovers are accomplished. Both results are non-value maximising and are deemed to increase agency costs. Another explanation of managerial opportunistic behaviour arises from real earnings management, which refers to "normal operational practices with the primary objective of meeting near-term earnings goal".²⁷³ Since predators normally target companies with weak governance, real earnings management—such as cutting research and development budgets—may lower the attractiveness of target firms and may thus sacrifice firms' long-term interests,²⁷⁴ thereby impairing shareholders' interests.

If workers can effectively participate in takeover decisions, such strategies adopted at the expense of shareholders and firm value can be forestalled. As insiders in the firm, shop-floor employees are clearly aware of the condition of firm assets such as company equipment, buildings, vehicles, and accordingly their approximate value. Therefore, if any valuation is carried out under the supervision of the employees, it is challenging to sell assets at below-the-market prices if workers' voices can be heard and valued by shareholders. Moreover, the sale of firm assets, especially plants and divisions, is expected to change relevant shop-floor employees' work conditions, leading to reduced job tenure and security.²⁷⁵ Workers therefore have a strong incentive to call out managers' opportunistic behaviour and convey news of such conduct to shareholders who have decisive powers over asset sales, in order to repel any corresponding adverse changes in their own life. In addition to curtailing managers using takeover defence tactics at the expense of shareholders' interests, workers' participation in the process of takeovers can prompt the management to enhance transparency and make them accountable for their decisions.²⁷⁶ This is particularly the case in the context of China, where the labour market is under-developed. Workers will struggle to find jobs elsewhere, making them bind closely with the firm, and

²⁷³ Y. Zhao, K.H. Chen, Y. Zhang, "Takeover Protection and Protection and Managerial Myopia: Evidence from Real Earnings Management" (2012) 31 *Journal of Accounting and Public Policy* 109.

²⁷⁴ K.A. Gunny, "The Relation between Earnings Management Using Real Activities Manipulation and Future Performance: Evidence from Meeting Earnings Benchmarks" (2010) 27 *Contemporary Accounting Research* 855.

²⁷⁵ B. Black, H. Gospel, and A. Pendleton, "Finance, Corporate Governance and the Employment Relationship" (2007) 46 *Industrial Relation: A Journal of Economy and Society* 643.

²⁷⁶ A. Christie and J. Zimmerman, "Efficient vs Opportunistic Choices of Accounting Procedures: Corporate Control Contests" (1994) 69 *The Accounting Review* 539.

accordingly they have a strong incentive to provide a check on any managerial incentives for opportunism.

For instance, in a management buyout of Pingdingshan Cotton Textile Co. Ltd in 2010, laid-off workers protested against an undervaluation of firm assets and the management's tunnelling behaviour, which was caused by the latter's collusion with the auditor.²⁷⁷ In such cases, if workers are given co-determination rights and accordingly able to exert a real influence on takeovers, such a loss of firm assets may be effectively avoided. This is because, as insiders, the shop-floor employees are clearly aware of the conditions of firm assets such as company equipment, buildings, vehicles, and accordingly their approximate value. In addition, workers' participation in the process of takeovers can prompt the management to enhance transparency and make them accountable for their decision-making, especially considering the workers' active role and ability to exert direct influence over managers. This is expected to reduce the chances of the management's manipulation in takeovers. Hence, employees are at an advantage in safeguarding firm assets compared with other stakeholders. Such advantages are even strengthened, considering that workers in China historically were perceived as the owners of firms and had the tradition of actively participating in firm management and supervision over executives.²⁷⁸

The differences in the objectives of shareholders and workers may conceivably constitute an obstacle to workers supervising the management, and therefore workers may not care about the loss of firm assets but may only consider their private interests. This is plausible, since each group of stakeholders has an incentive to maximise their own interests, and accordingly the stronger power of employees is expected to intensify their distributional conflict with shareholders. That is to say, workers fighting for their interests may lead to shareholders getting a smaller slice of the pie of firm value. However, whether this hurts their interests is debatable, since stronger worker involvement is expected to increase productivity, making the "pie" larger. However,

²⁷⁷ S. Wang, "A Discussion on the Labour Protection Mechanism in the SOE Reform" (国企改制过程中职工利益保护机制探讨) (2011) 1 *China Human Resources Development* (中国人力资源开发) 84.

²⁷⁸ Z. Wang, "Corporate Governance under State Control: the Chinese Experience" (2012) 13 *Theoretical Inquiries in Law* 487.

it should be noted that in terms of supervision of the management in takeovers, workers' interests align with those of shareholders. This is because shareholders and employees are both against the managerial pursuit of private interests. The rationale of the former is the objective of shareholders to reduce agency costs, arising from their agency relationship with the management. Although the relationship between employees and the employer is perceived as a contractual rather than agency relationship, managers' opportunistic behaviours, such as unfair layoffs, may breach employees' implicit trust in the management.²⁷⁹ In the context of takeovers, the undervaluation of the firm's assets will reduce the overall takeover returns, which eventually reduces shareholder gains and the money allocated for workers' arrangements. On the other hand, in terms of the distributional conflict between shareholders and employees, a worker representational participation system can carry workers' voices directly to the shareholders, which can minimise managerial opportunistic behaviour whereby they seek to enhance their private benefits on the pretext of safeguarding employees' interests.

Another concern expressed is that it may not be feasible for workers to supervise the behaviour of management in takeovers. To begin with, shop-floor workers may lack knowledge and experience in supervising the management. However, this apprehension is invalid since the supervision of managers does not require workers to possess any managerial ability, as these are skills that management have ostensibly mastered. As insiders and significant stakeholders in the company, workers have first-hand information on production and firm assets, which are not shared even by supervisory members. As a supplement to the supervision organ, workers only need to express their voice from their own perspective. It is at the discretion of shareholders to determine whether to treat them as valid. Another factor that affects the practicability of workers supervising managers is asymmetry of information.²⁸⁰ However, this view is not reasonable when it comes to workers' rights being involved, since employees being informed in time and adequately is a prerequisite to the exercise of their participation right.

²⁷⁹ Shleifer and Summers (n 78).

²⁸⁰ P. Davies, "Efficiency Arguments for Collective Representation of Workers: A Sketch" in A. Bogg, C. Costello, A. Davies and J. Prassl (eds), *the Autonomy of Labour Law* (Hart Publishing-2014) 367.

The Employer–Employee Agency Relationship

The employer and employee relationship is also subject to agency problems, and it is the objective of the employer to minimise them. Scholars have identified several forms of withholding efforts in the employment relationship based on workers' performance and motivation, which include shirking, job neglect, free riding, and social loafing.²⁸¹ The first two forms focus on workers' performance when they work alone. Shirking occurs when workers have a tendency to put in less effort and have more leisure time at work,²⁸² while job neglect is a variation of shirking, referring to the phenomenon of employees using work time for non-work-related purposes.²⁸³ The last two forms occur in the group context, and have similar meanings. Free riding occurs when workers draw benefits from group work but do not bear their proportionate costs in the realization of that benefit,²⁸⁴ whereas social loafing emphasises the incentives of workers to reduce their level of effort because it is impossible for others to determine each of their respective contributions.²⁸⁵ It has been suggested that behaviour such as shirking and job neglect can be addressed by close monitoring by their supervisors or the adoption of a preventive incentive mechanism such as paying above-average wages. However, such discipline is deemed as too costly for firms, since supervisors also need to be paid,²⁸⁶ whereas managers can hardly monitor employees directly.²⁸⁷ Accordingly, incentive mechanisms such as a compensation policy scheme have gained more support.²⁸⁸ However, this may lead to the free-rider problem and social

²⁸¹ N. Bennett and S.E. Naumann, "Withholding Efforts Understanding and Preventing Shirking, Job Neglect, Social Loafing, and Free Riding" in R.E. Kidwell and C.L. Martin (eds), *Managing Organizational Deviance* (Sage Publications-2004) 113.

²⁸² A. Leibowitz and R. Tollison, "Free Riding, Shirking and Team Production in Legal Partnerships" (1980) 18 *Economic Inquiry* 380.

²⁸³ V.K.G. Lim, "The IT Way of Loafing on the Job: Cyberloafing, Neutralizing, and Organizational Justice" (2002) 23 *Journal of Organizational Behavior* 675.

²⁸⁴ R. Albanese and D. Van Fleet, "Rational Behavior in Groups: The Free-Riding Tendency" (1985) 10 *Academy of Management Review* 244.

²⁸⁵ N.L. Kerr and S. Bruun, "The Dispensability of Member Effort and Group Motivation Losses: Free Rider Effects" (1983) 44 *Journal of Personality and Social Psychology* 78.

²⁸⁶ J.H. Pencavel, "Work Effort, On the Job Screening, and Alternative Methods of Remuneration" in S. Polanchek and K. Tatsiramos (eds), *35th Anniversary Retrospective (Research in Labor Economics, Vol. 35)* (Emerald Group Publishing-1997) 537.

²⁸⁷ P. Cappelli and K. Chauvin, "An Interplant Test of the Efficiency Wage Hypothesis" (1991) 106 *The Quarterly Journal of Economics* 769.

²⁸⁸ E. Lazear and S. Rosen, "Rank Order Tournaments as Optimum Contracts" (1981) 89 *Journal of Political Economy* 841.

loafing, since any individual's failure to contribute full efforts does not affect the group's performance. Therefore, it is claimed that this problem can be mitigated by establishing a high trust relationship,²⁸⁹ and an employee participation scheme is one attempt to encourage this relationship. In addition, surveys find that most workers can detect whether their colleagues are shirkers, and they are willing to take active action such as speaking to shirkers or reporting to supervisors if there is an employee involvement mechanism.²⁹⁰ Hence, establishing an employee involvement mechanism can also function in reducing employer–employee agency costs.

In the context of hostile takeovers, workers tend to withhold efforts at work due to uncertainty about their treatment following restructuring after the takeover. If workers can obtain information and actively participate in takeover decisions, their trust in managers is more likely to rise, and therefore they are more likely to put in effort in their job, which will reduce employer–employee agency costs.

2.2.4 Conclusion

This section has examined the economic rationales for employee involvement in corporate governance, laying the economic grounds for improved worker participation in hostile takeovers from three perspectives. First, deeper involvement of employees in corporate management improves workers' job satisfaction and job commitment, which positively affects firm productivity and value. In this light, if workers are allowed to participate in takeover decisions, when they are particularly vulnerable to unjust treatment, firms' productivity is likely to be positively affected, due to the rise in job satisfaction and job commitment. Second, inspired by the incomplete contract theory, employees' investments in the employment contractual relationship cannot be specified in advance. Accordingly, when employees feel uncertain about their future following any likely restructuring after takeovers, they tend to withhold their firm-specific investments. Since hostile takeovers may take years to be completed, hold-up problems tend to negatively affect firm productivity, which lowers returns for the

²⁸⁹ W. Ouchi, "Markets, Bureaucracies and Clans" (1980) 25 *Administrative Science Quarterly* 129.

²⁹⁰ R. Freeman, D. Kruse and J. Blasi, "Workers Responses to Shirking under Shared Capitalism" (2008) No. w14227 *National Bureau of Economic Research*, available at <https://www.nber.org/papers/w14227.pdf>.

incumbent shareholders. In addition, this increases the chances of negative treatment of employees due to their poor performance. Third, employee involvement in takeover decisions can reduce the costs of two sets of agency relationships: the shareholder–manager relationship and the employer–employee relationship. With regard to the former, employees have an incentive to place checks on managerial opportunism, and an employee involvement scheme can provide such channels. In hostile takeovers, this can effectively forestall managers’ opportunistic behaviour for their own benefit at the expense of employees and shareholders. As for the latter, an employee involvement mechanism can deter workers’ tendency to withhold effort during their work. In hostile takeovers, when workers are more likely to withhold their efforts at work, their participation in the takeover decision can help to establish a high trust relationship with the employer, thus precluding such tendencies.

In conclusion, an employee involvement scheme in takeover decisions can positively affect workers’ productivity both before and during hostile takeovers, which positively affects firm value. However, excessive labour intervention in takeover decisions may raise labour costs significantly, exceeding the increase in productivity and leading to a decrease in firm value. Therefore, employee involvement should be maintained at a carefully tailored, moderate level.

Having built the theoretical and economic framework for enhancing labour participation mechanism in Chinese takeover law, this thesis moves on in Chapter 3 to identify the factors that deter effective employee protection in Chinese firms. It then goes on to propose solutions that address these problems.

Chapter 3: Labour Participation Mechanisms in the Context of Hostile Takeovers in Chinese Firms

Based on the foregoing analysis, it is clear that workers need to be protected and involved in hostile takeovers, given their vulnerability to unjust treatment. However, the existing employee protection and participation mechanism in Chinese firms is perceived as ineffective, which runs against the interests of employees as well as the firm as a whole. The objective of this chapter 3 is to examine the reasons for this ineffectiveness and provides directors to resolve these problems, and it begins with a summary of the extant employee participation mechanism in Chinese firms.

3.1 A Summary of the Legal Framework

In the context of takeovers, workers are concerned about two aspects: the takeover's impact on the employees and on the target firms when employees are transferred to a new employer. The former is related to employee's contracts, whereas the latter concerns participation rights in decision-making. Turning to the first concern, Articles 33 and 34 of China's Labour Contract Law²⁹¹ provide as follows:

Article 33: An employer's change of name, legal representative, key person-in-charge or investor shall not affect the fulfilment of employment contracts.

Article 34: In cases of firm mergers, splits, or other circumstances, the original employment contracts remain valid. Such contracts shall be performed by the new employer, who succeeds the rights and obligations of the aforesaid employer.

These rules can be applied to sales of both undertaking(s) and shares, which includes hostile takeovers. The new employer is obliged to inherit the employees of the target company, along with their employment contracts. However, considering that takeovers

²⁹¹ *The Labour Contract Law of People's Republic of China (中华人民共和国劳动合同法)(2012)* (The Labour Contract Law of PRC).

often lead to the restructuring of the firm, it is inevitable that certain terms in the contracts are modified, although this should be agreed upon by both the employer and employees.²⁹² The trade union is the organ that negotiates the collective employment contracts with the management of the acquirer company.²⁹³ Thereafter, the contract drafts should be referred to the Workers' Congress for approval.

As regards participation rights, workers can participate in takeovers at both the establishment and board levels. The core institutions at the establishment level are the trade union and the Workers' Congress, which is confirmed by the Company Law²⁹⁴ as follows:

***Article 18:** To make a decision on restructuring or any important issue relating to business operations... a company shall solicit the opinions of its trade union and shall solicit the opinions and proposals of the employees through the Workers' Congress or in any other ways.*

The scenario where a firm is acquired has been interpreted as included within the phrase: "important issue relating to business operations", and therefore the trade union and the Workers' Congress should be informed and consulted directly before the takeover decision is made.²⁹⁵

Employees can also express their voice through their representatives on the board of directors (BoD) and the board of supervisors (BoS).²⁹⁶ These are the core management and supervision organs in Chinese firms, which can directly participate in takeover decisions, although the shareholder assembly retains its decisive power. The institutional structure is illustrated in diagram 1.

²⁹² Article 35 of the *Labour Contract Law of PRC*.

²⁹³ Article 20 of the *Trade Union Law of Peoples' Republic of China* (《中华人民共和国工会法》) (2009) (The Trade Union Law of PRC).

²⁹⁴ *The Company Law of PRC*.

²⁹⁵ Although a workers' right to be informed is not explicitly provided for in this rule, I assume Chinese legislation endows workers with such right because it is a pre-condition of being consulted that one is first informed.

²⁹⁶ Article 51 and 108 of the *Company Law of PRC*.

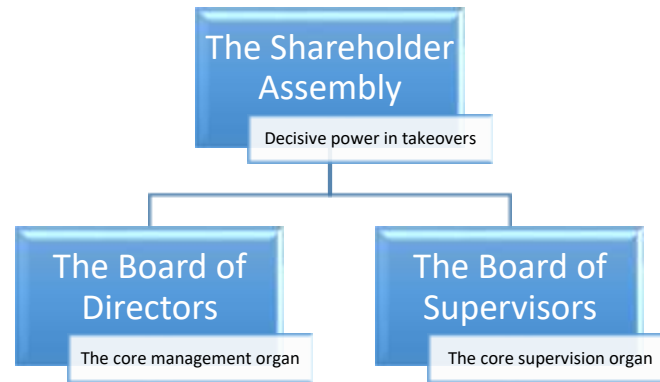


Diagram 1: corporate organs in Chinese companies

Chinese laws appear to provide strong protection for the employees in a firm, but in fact their actual functioning is weak in practice. Since the trade union has the right to nominate and the Workers' Congress can elect their representatives on the BoD,²⁹⁷ these two organs are located at the centre of the labour participation mechanism in takeovers. Therefore, this chapter first examines the effectiveness of the employee participation mechanism at the establishment level.

3.2 The Workers' Congress

This section starts with a brief description of the Workers' Congress, and thereafter moves on to identify the reasons why this organisation cannot function well under the existing corporate governance system in China.

3.2.1 Introduction to the Workers' Congress

The Workers' Congress is an institution that allows employees to directly participate in the management of an enterprise.²⁹⁸ It is currently prevalent in both state-owned and privately-owned enterprises.²⁹⁹ Under this mechanism, employees or their

²⁹⁷ Article 38 of the *Provisions on the Democratic Management of Enterprises* (企业民主管理规定) (2012) (Democratic Management Measures).

²⁹⁸ People.cn (人民网), "Three. Workers' Congresses and Self-governance of Enterprises" (2017), available at <http://en.people.cn/92824/92845/92869/6439952.html>.

²⁹⁹ As at the end of 2012, 80.8% of enterprises with trade unions had established the Workers' Congress system. See All-China Federation of Trade Unions Research Department, *2012 Trade Union Organisation and Work Development Statistics* (2012 年工会组织和工会发展状况统计公报) (2013), available at

representatives (if the number of employees exceeds 100)³⁰⁰ are organised by the trade union to hold meetings at least annually. The main functions of the Workers' Congress in corporate governance are as follows:³⁰¹

1. To be consulted on vital matters such as the business management and vital matters that closely relate to the labour interests, including work hours, labour welfare, and occupational safety and health;
2. To deliberate and approve collective employment contracts;
3. To elect or recall employee representatives to or from the board of directors and the board of supervisors;
4. To supervise the firm's implementation of labour laws and regulations and appraise the work of the central management of the enterprise; and
5. In state-owned enterprises, to deliberate upon and approve plans for layoffs and the resettlement of employees in the enterprise's merger, split, restructuring, or bankruptcy.³⁰²

When the Workers' Congress is not in session, the trade union is obliged to oversee the board of directors to implement the decisions of the Workers Congress.³⁰³

Based on the above description, workers' participation in business management through the Workers' Congress appears to be extensive. However, employees' voices are in effect not heard or valued by the BoD, for two main reasons. The first is that it is an institution that was embedded in the old planned and socialist economic system, making it incompatible with the modern corporate governance system that has been transplanted from western countries. The second is the ineffectiveness of the trade union which is to guarantee the performance of the Workers' Congress. This is because the trade union is obliged to organise the meetings of the Workers' Congress and urge and oversee the BoD to implement the decisions of the Workers' Congress. Therefore, whether the Workers' Congress functions effectively depends heavily on the attitude

stats.acftu.org/upload/files/1370483520528.pdf.

³⁰⁰ Article 8 of *Democratic Management Provisions*.

³⁰¹ Article 13 of *Democratic Management Provisions*.

³⁰² Article 14 of *Democratic Management Provisions*.

³⁰³ Article 22 of *Democratic Management Provisions*.

and approach of the trade unions. Their ineffectiveness attenuates the functions of the Workers' Congress to a large extent. The first reason is analysed in the subsection 3.2.2 and 3.2.3 whilst the second is examined in section 3.3.

3.2.2 The Workers' Congress' Incompatibility with the Corporate Governance System in China

In order to examine how the Workers' Congress is incompatible with modern corporate governance in China, this subsection first introduces the history of the Workers' Congress to identify its original role in Chinese firms. It then goes on to describe the current corporate governance system in China and examines how the Workers' Congress cannot fit properly into this system.

The Workers' Congress: Some History

The mechanism of the Workers' Congress has experienced a chequered history, with “sudden surges into activity and lapses into formalism”.³⁰⁴

This organ was designed to demonstrate the workers' role as the “master” of the enterprise.³⁰⁵ In 1949, with the founding of the People's Republic of China (PRC), the working class's leading role was confirmed in constitutional law.³⁰⁶ Thereafter, in the then operational business enterprises, the Workers' Representative Committee (the predecessor of the Workers' Congress) acted as the decision-making or ‘authority organ’ to some extent as well as the supervisory organ.³⁰⁷ The ‘authority organ’ is a reference to the committee's substantial effects on decision making regarding major issues concerning the management of enterprises. The ‘supervisory organ’ stressed its

³⁰⁴ X. Zhu and A. Chen, “Staff and Workers' Representative Congress” (2005) 37 *China Sociology and Anthropology* 6 at 8.

³⁰⁵ ACFTU, *the Resolution concerning the Current Task of Chinese Staff Movement* (关于中国职工运动当前任务的决议) (1948) available at http://px.worker.cn/c/2011/02/19/110210152352995960548_2.html.

³⁰⁶ Article 1 of *Common Program of the Chinese People's Political Consultative Conference* (中国政治局协商会议共同纲领) (1949). This acted as a temporary constitutional law until 1954, when the leading role of the workers was further confirmed in the first formal constitutional law in China.

³⁰⁷ Z. Xie, “The Remodelling of the Position and Function of the Workers' Congress” (“职代会定位与功能重塑”) (2013) 35 *Chinese Journal of Law* (法学研究) 110.

supervisory power over the factory director, who took full responsibility for the management and operation of the enterprise.³⁰⁸ In particular, workers had the right to make suggestions to the factory director on all major issues regarding business management as well as to the superior government body to remove the factory director if necessary.³⁰⁹ In effect, the supervisory power of the workers was guaranteed by the state during this period, especially considering the latter had an urgent need to consolidate its political power.

However, the support of workers' participation rights from the state became attenuated as the needs of the state changed, especially during political movements such as the *Anti-Rightist Movement* and the *Cultural Revolution*.³¹⁰ In the ensuing political chaos, the employees' representative committee was encouraged to deviate from its supervisory function and focus on the political movement instead.³¹¹

Starting from the end of the *Cultural Revolution*, the Workers' Congress experienced a revival until the early 1990s. During this period, workers' rights to participate in the democratic management of the enterprise, the basic form of which was the Workers' Congress, was confirmed in law.³¹² This was mainly due to the impact of the "Polish Crisis", when workers organised and rebelled against the communist regime in Poland in the 1980s. In order to avoid a similar crisis in China, labour interests once again were emphasised by the state, and accordingly the Workers' Congress became more active.³¹³ This is demonstrated by a survey on the functioning of the Workers'

³⁰⁸ Chapter 3 of *the Implementing Regulation on the Establishment of the Factory Management Committee and Factory Workers' Representative Meeting in State-operated and Public-operated Enterprises* (关于在国营公营工厂企业中建立工厂管理委员会与工厂职工代表大会的实施条例) (1950).

³⁰⁹ The Central Committee of CPC, *The Directive Concerning Several Important Problems in Regard to the Working Class* (关于研究有关工人阶级的几个重要问题的通知) (1949), available at <http://cpc.people.com.cn/GB/64184/64186/66664/4493186.html>.

³¹⁰ S. Zheng, "Chinese Staff Congress System: The Past, Present and Future" (2012) *The Japan Institute for Labour Policy and Training Comparative Labour Seminar* 131, available at http://www.jil.go.jp/english/reports/documents/jilpt-reports/no.11_china.pdf.

³¹¹ H. Cai and X. Li, "The Practice Research on the System of Staff Representative Committee in SOEs" (国有企业职工代表大会制度时间研究) (2014) 5 *Opening Times* (开放时代), available at <http://www.opentimes.cn/Abstract/1979.html>.

³¹² Article 48 of *The Law of the People's Republic of China on Industrial Enterprises Owned by the Whole People* (中华人民共和国全民所有制企业法) (1988).

³¹³ J.L. Wilson, "The Polish lesson: China and Poland 1980–1990" (1990) 22 *Studies in Comparative Communism* 259.

Congress, which found that workers indeed enjoyed high participation rates in the management of the enterprise.³¹⁴

However, the Workers' Congress gradually became formalistic when the modern corporate governance system was introduced in the early 1990s. Since then, the Workers' Congress has become incompatible with the extant corporate governance system in China. This incompatibility is analysed in detail in subsection 3.2.3 below.

Two conclusions can be drawn from the history of the Workers' Congress. First, the effectiveness of the functioning of the Workers' Congress depended heavily on the state's willingness to safeguard labour interests in the planned economy, and this organ's reliance on the state has continued until now. Although the state has reduced its intervention in the corporate governance of both state-owned and private-owned enterprises substantially, the influence of the state in labour protection is still enormous. This is mainly because the trade unions, which are responsible for organising the Congress and implementing employees' decisions, is under the leadership of the Communist Party of China (the sole ruling party of PRC), similar to the situation in the past. Therefore, the party and the state's strong motivations for safeguarding the interests of the workers affect the effectiveness of the trade unions, and accordingly the Workers' Congress to a large extent. This is discussed in greater detail in section 3.3 below, which mainly discusses the ineffectiveness of the trade unions.

The second conclusion is that the Workers' Congress was originally designed in a totally different corporate structure from that prevailing today. In the old planned economy where almost all of the enterprises were state-owned, the factory director was the management organ whilst the Workers' Congress and the trade unions mainly acted as the supervisory organs. The supervisory power of workers came from the notion that the workers were in some vague way the owners of the enterprise,³¹⁵ which

³¹⁴ X. Zhu and P. Chen, "Workers' Congress: Institutionalised Voice Channel for Workers" (职工代表大会：职工利益的制度化表达渠道?) (2002) 3 *Opening Times* (开放时代), available at <http://ww2.usc.cuhk.edu.hk/PaperCollection/Details.aspx?id=2267>.

³¹⁵ See L. Sun, *Transformation and Fracture: The Transition of Social Structure after the Reform* (转型与断裂：改革以来中国社会结构的变迁) (Tsinghua University Press-2004) 240.

was due to their role as the masters of the state. At this time, the workers were deemed to benefit from the “iron rice bowl”, which was a reference to “the system of guaranteed lifetime employment in state enterprises”.³¹⁶ With such a high level of job stability, workers could freely express their discontent without worrying about losing their jobs. However, in the modern corporate governance system, the board of supervisors is the main supervisory organ, and this has replaced most of the supervisory power of the Workers’ Congress. In addition, workers have changed from being the vague owners of the firm to employees under a contractual relationship, which means that their jobs are not as stable as before, and the source of their supervisory function in corporate governance had to undergo a corresponding change. The main reason for workers to supervise the management of the board of directors seems to be that they closely relate their welfare with the firm, and their participation in corporate governance positively relates to the firm value, which is elaborate in section 2.2.

The Current Role of the Workers’ Congress in Firms

The preceding discussion made the point that the Workers’ Congress was embedded in the old planned economy where the structure of corporate governance and relevant governance bodies were completely different. Starting from the early 1990s when the modern enterprise system was introduced into China, a series of corporate laws were promulgated, including the first Company Law in 1993.

Briefly, in accordance with Chinese laws,³¹⁷ the organisational structure of Chinese firms consists of three bodies, with the shareholder assembly as the authority organ, the BoD as the management organ, and the BoS as the main supervisory organ. The functions of these organs seem distinct and mutually exclusive, leaving no room for the Workers’ Congress to perform its functions to safeguard the interests of labour.³¹⁸ The Workers’ Congress with decidedly Chinese features found it challenging to fit

³¹⁶ BBC News, “Iron Rice Bowl” (2017), available at http://news.bbc.co.uk/1/hi/english/static/special_report/1999/09/99/china_50/iron.htm.

³¹⁷ In particular *the Company Law of PRC*.

³¹⁸ S. Zheng (n 310) 145.

within the new-established legal system. Two aspects of this incompatibility are now examined.

First, the Workers' Congress is no longer able to exert substantial influence over the decision-making process regarding major issues. Using takeovers as an example, the shareholder assembly has the power to approve or reject a takeover plan, whereas the Workers' Congress only has the right to be consulted. In order to approve or reject a potential takeover plan, the BoD need only persuade the shareholder assembly, rendering the suggestions from the employees futile if their opinions conflict with those of the shareholders.³¹⁹ However, if the workers think their views are not fully respected by the BoD, they may shirk or even maliciously stop their work,³²⁰ which may delay or even frustrate the process of the takeover. In response to this potential conflict, since there is no rule on when the Workers' Congress should be consulted, the BoD tends to inform the workers of the takeover just before the takeover is completed,³²¹ leaving very little time or room for the workers to frustrate the takeover. Even where the BoD breaches the requirement of implementing the mechanism of the Workers' Congress, there are few effective remedies for the workers. For instance, the trade union has the power to request the BoD to correct their conduct, but the laws do not provide further remedies when the BoD rejects such requests.³²² Therefore, workers tend to be forced to agree with the takeover plan even when their interests are neglected, especially when there is evidence showing that any expression of dissent will increase the workers' chances of being laid off.³²³

Second, the supervisory function of the Workers' Congress was replaced by the BoS to a large extent, which has weakened the former's power as a result. According to

³¹⁹ Article 4 of the *Labour Contract Law of PRC*.

³²⁰ P. Li, "Beyond the Failure of Promulgation of the Regulations on the Democratic Management of Enterprises" (广东企业民主管理条例难产背后) (2010). *Economy and Nation Weekly* (财经国家周刊), available at <http://finance.sina.com.cn/q/20101011/12188757381.shtml>.

³²¹ This is the case in China Resources Healthcare Group Ltd.'s takeover of a hospital in Jilin Province in 2016. See Tencent News, "Doubts on of CR Medical's Acquisition of The 4th Hospital of Jinli University" (华润医疗收购吉大四院遭质疑) (2017), available at <http://stock.qq.com/a/20161228/002581.htm>.

³²² Article 19 of the *Trade Union Law of PRC*.

³²³ J. Andreas, "Losing Membership Rights: The Impact of Eliminating Permanent Job Tenure on Power Relations in Chinese Factories" in C. Estlund, "Will Workers Have a Voice in China's 'Socialist Market Economy'? The Curious Revival of the Workers Congress System" (2013) *New York University Public Law and Legal Theory Working Papers* (Paper 440) 9.

Chinese Company Law,³²⁴ the BoS has the power to oversee the work of the BoD and the senior management financially and legally. It is also a supervisory organ to safeguard the interests of labour, considering that the employee representatives should comprise no less than one-third of the composition of the BoS.³²⁵ Since the division of powers between the BoS and the Worker's Congress has not been clarified in legislation,³²⁶ there is a huge functional overlap between these two organs. However, compared with the Workers' Congress, the BoS has more effective mechanisms to implement its supervisory power, if they find that the activities of the BoD or senior management are against the laws or hurt the interests of the firm. For example, they can propose to hold an interim meeting of the shareholder assembly to request the shareholders to correct the conduct of the BoD or the senior management, or they can directly sue in court.³²⁷ On the other hand, the Workers' Congress is not allowed to communicate with the shareholders or sue in court, making its supervisory functions more formalistic.

In short, the supremacy of the shareholder assembly renders the Workers' Congress's ex ante participation rights in major decisions of the company quite redundant, whereas the BoS weakens the ex post supervisory function of the Workers' Congress. As the basic mechanism of democratic management for employees, the Workers' Congress has not found its proper position in the current Chinese corporate governance system.

3.2.3 Conclusion

The Workers Congress was designed in the old planned economy, where the corporate governance structure and the role of the workers in the firm were totally different from what obtains today. Except for the periods of political turbulence in China, the Workers' Congress could exert extensive influence on decision making regarding

³²⁴ Article 51 and 53 of *the Company Law of PRC*.

³²⁵ The BoS is also blamed as ineffective in both its supervisory functions and labour protection, and this is discussed in section 3.4.

³²⁶ Y. Li, Z. Guo, and Y. Bai, "Legal Suggestions for the Workers' Congress's Participation in Corporate Governance" ("职工代表大会参与公司治理的法律完善") (2013) 6 *Journal of China Academy of Governance* (国家行政学院学报) 59 at 61.

³²⁷ Article 53, 149, and 151 of *the Company Law of PRC*.

major issues of business management whilst having the supervisory power over the factory director. However, under the current corporate governance system, which is transplanted from other countries such as the UK, the US, and Germany, the Workers' Congress cannot function well. For example, since the shareholder assembly has the power to decide on major issues of business management, the BoD tends to treat suggestions from the employees as pointless or even an obstacle to implementing the decisions made by the shareholder assembly. In addition, the supervisory power of the BoS overlaps with that of the Workers' Congress. Since the BoS has more powerful mechanisms in place to exercise their power, such as suing the BoD in court, the supervisory functions of the Workers' Congress are further reduced.

As mentioned in Section 3.2.1, the Workers' Congress for its effectiveness relies heavily on the trade unions, but the latter are ineffective, as the next section explores.

3.3 The Trade Unions

Similar to the Workers' Congress, the trade union seems to provide strong protection to the employees in the firm, but in fact their actual functioning is weak in practice. This section provides a brief introduction of the Chinese trade union to examine the seemingly strong protection it offers, before identifying the reasons of its ineffectiveness.

3.3.1 Introduction to the Trade Unions in China

The trade union is another basic form of democratic management for workers and it can provide strong protection for the workers in Chinese firms. This point can be substantiated in light of its functions, which are stipulated in the Trade Union Law as follows:³²⁸

1. To participate in decision-making on major issues concerning labour interests. In the context of takeovers, in addition to the Workers' Congress, the trade union is

³²⁸ Article 19-28 of the *Trade Union Law of PRC*.

another organ that must be consulted by the BoD.

2. To organise the Workers' Congress and assist in the implementation of the decisions of the Workers' Congress. If the firm prevents the work of the Workers' Congress, the trade union has the power to request corrections.
3. To oversee whether the BoD and the senior management infringe labour interests. If there is an infringement such as unjustified dismissal or non-payment of salaries, the trade union is obliged to request corrections or to report to the government. If the firm breaches any collective employment agreements, the trade union can also initiate legal action against the firm.
4. To help resolve labour conflicts between the employer and the employees.

In terms of the first function, the reason for the ineffectiveness of the trade unions is similar to that applicable in the case of the Workers' Congress, which was discussed in Section 3.2.2. In brief, the trade unions cannot exert any material influence on the decision-making of the BoD, which renders any consultation with the trade union meaningless.

Two factors render the trade union ineffective in the other three functions. The first is the dual objective, which is caused by the organisational structure of the trade union system in China. The second is a lack of independence from the firm. The next two subsections respectively examine these problems.

3.3.2 The Dual Objectives of the Trade Union

In addition to safeguarding the interests of the workers, the trade union has the objective of serving the interests of the party-state, which is a reference to the close ties between the interests of the Communist Party of China (CPC) and the state. The additional objective regarding the party-state is attributable to the two organisational structures to which the trade union is subordinated. These structures can be seen in diagram 2.

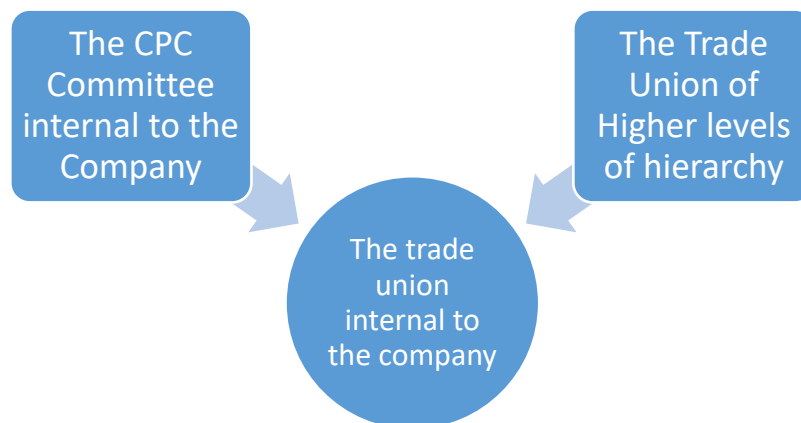


Diagram 2: the organisational structures of the trade union in the Chinese company

The first is that the trade union should primarily be led by the CPC committee in the firm.³²⁹ The objectives of the CPC are to implement the policies of the party-state and oversee the management of the firm in case it adversely affects the latter's interests.³³⁰ Such leadership of the CPC committee gives the trade union an additional objective, which is to safeguard the interests of the party-state. Where the party-state's interests conflict with the those of the employees, the trade union cannot fully support the workers, but must instead act as a "transmission belt" to help the party-state negotiate with the employees.³³¹ A more severe problem will be generated in the case of state-owned enterprises, where the leaders of the CPC committee are also senior managers of the firm. This can be illustrated by the takeover of Tuopai Shede Wine Co. Ltd in

³²⁹ Article 20 of *Measures for Election of the Trade Union Chairman in an Enterprise* (《企业工会主席产生办法》) (2008).

³³⁰ A detailed description of the role of the CPC committee in the Chinese company is made in section 4.3.1.

³³¹ General Provisions of the *Trade Union's Chapter* (《中国工会章程》) (2013).

2016. In this case, the trade union was silent in face of the harm caused to the interests of labour, mainly because the takeover was a decision made by the party-state.³³²

The second is that the trade union operates under a hierarchical system, at the top of which one finds the All-China Federation of Trade Unions (ACFTU). This organisational structure further strengthens the control of the party-state over the trade unions. In particular, the trade unions at all levels should be under the leadership of the party-state, which is demonstrated by the party-state's power to appoint leaders.³³³ In addition, any workers' organisation operating outside this system is deemed to be illegal,³³⁴ thereby eliminating any possibility of the emergence of any trade union outside the control of the party-state.

These organisational structures date back to the old planned economy. At that time, the leadership of the party-state was reasonable to some extent, since the workers did not have the capability to participate in the democratic management and needed help from the party-state.³³⁵ However, such paternalistic control by the party-state is not advisable nowadays, especially considering the emergence of more than 50 labour organisations outside the abovementioned hierarchical system as of 2013.³³⁶ This phenomenon is representative of the increasing need of workers for independent trade unions, although these organisations were repressed in the end due to their illegal status.³³⁷

A question may arise that since private firms' connection with the party-state is not as close as that in state-owned enterprises, therefore it should rarely be seen that the interests of the party-state are prioritised at the expense of employees' welfare.

³³² Sina Finance, "Arrangements of Employees in the Case of Mixed Ownership Reform of Tuopai Shede" (从沱牌舍得集团混改看国企员工安置) (2016), available at <http://finance.sina.com.cn/roll/2016-04-08/doc-ifxrcizs7010376.shtml>.

³³³ *The Regulation on the Selection and Appointment of the Party and Government Leaders* (党政领导干部选拔任用工作条例) (2014).

³³⁴ Article 2 of the *Trade Union Law of PRC*.

³³⁵ P. Li (n 320).

³³⁶ Y. Xu, "Labor Non-governmental Organizations in China: Mobilizing Rural Migrants" (2013) 55 *Journal of Industrial Relations* 243 at 246.

³³⁷ J. Howell, "Shall We Dance? Welfarist Incorporation and the Politics of State-labour NGO Relations in China." (2015) 223 *China Quarterly* 702.

However, the fact is that in China which adopts the state-capitalist system where the party-state retains commanding heights in the Chinese economy,³³⁸ corporate decisions are significantly affected by the party-state, mainly through regulatory and non-regulatory methods.

As for the former, private firms are regulated by administrative organs such as CSRC (the department that regulates and supervises the capital market, including listed companies) and the Ministry or Bureau of Human Resources and Social Security (which is an institution that has the responsibility to regulate the labour market, promote employment, and procure social security). These administrative organs may affect major corporate decisions through regulatory governance measures, such as administrative approval, orders, or instructions. This is especially the case in takeovers, which attract much attention from the CSRC,³³⁹ which is the principal organ that has discretion to approve or veto a takeover plan.

As regards the deployment of non-regulatory methods, since all the major banks in China are state-owned, firms having strong political connections will increase their chances of receiving loans, possibly at a lower cost.³⁴⁰ In addition, the firms with a close relationship with the party-state are more likely to benefit from favourable government policies, such as tax reductions³⁴¹ or subsidies.³⁴² Such a relationship with the party-state is mainly formed for two reasons. The first is the government's dependence on local firms for tax revenues and the execution of policy objectives. To be specific, the amount of tax revenue is an important criterion to assess the performance of the local government, while there are also some policy objectives, such as increasing the volume of exports, which need solid support from local companies.

³³⁸ I. Bremmer, "State Capitalism Comes of Age" (2009) 88 *Foreign Affairs* 40.

³³⁹ It has been reported that the CSRC have issued 361 Inquiry Letters relating to takeovers and their subsequent restructurings in 2017, which significantly shapes the takeover decisions of listed firms in China. Securities Times CN, "Strict Overseeing Becomes Common; Mergers and Acquisitions Attract More Attention from CSRC" (2018), available at: <http://www.stcn.com/2018/0102/13874472.shtml>.

³⁴⁰ C.K.W. Chow, M.K.Y. Fung, and K.C.K. Lam, "Investment Opportunity Set, Political Connection and Business Policies of Private Enterprises in China" (2012) 38 *Review of Quantitative Finance and Accounting* 367.

³⁴¹ W. Cui, "Taxation of State-Owned Enterprise: A Review of Empirical Evidence from China" (2015) in Liebman and Milhaupt (Eds.), *Regulating the Visible Hand* (n 135) 154.

³⁴² U.C.V. Haley and G.T. Haley, *Subsidies to Chinese Industries: State Capitalism, Business Strategy, and Trade Policy* (Oxford University Press-2013) 2. In 2015, 2752 listed companies obtained RMB 167.3 billion from the government, available at: <http://news.xinhuanet.com/finance/2016-05/06/c128962597.htm>.

The second is the personal relationship between the members of the management and government officials. Although the administrative organs have procedural rules on how to implement their powers, “real authority in China is concentrated in the hands of political elites and is not subject to systematic monitoring by the public or politically independent institutions”.³⁴³ Therefore, a close relationship with the key figures in the government will enhance firms’ intimacy with the government, thereby helping them avoid arbitrary administrative actions. As a result, even in private firms where the party-state does not have controlling shareholding, the party-state retains a close relationship with the firm, making the interests of the party-state a pivotal consideration in takeover decisions.

Hence, the organisational structures that are in place make the trade unions under the leadership of the party-state very powerful rather than the workers, and thereby reduce their labour protection function. Confronted by the interests of the party-state, the interests of labour will be even less protected since the party-state’s interests are normally prioritised in the Chinese context.

3.3.3 A Lack of Independence from the Firm

The major role of the trade unions is to protect the workers from the firm, which means that a lack of independence from the firm will attenuate their functions substantially. This lack of independence has two main aspects:

First, the chairman of the trade union normally holds a concurrent post as a senior manager in the firm,³⁴⁴ which is not prohibited by Chinese law.³⁴⁵ The senior management leader may improve the status of the trade union within the firm,³⁴⁶ but

³⁴³ C.J. Milhaupt and W. Zheng, “Why Mixed-ownership Reforms cannot fix China’s State Sector” (2016) *Paulson Policy Memorandum* 14, available at http://www.paulsoninstitute.org/wp-content/uploads/2017/01/PPM_SOE-Ownership_Milhaupt-and-Zheng_English_R.pdf.

³⁴⁴ X. Liu and Q. Zhang, “Survey on the Concurrent Post of the Chairman of the Trade Union” (关于工会主席兼职情况的调查) (2010) 4 *Chinese Workers’ Movement* (中国工运) 19. According to this survey, 79.5% of the chairmen have a concurrent post in the enterprise.

³⁴⁵ Article 9 of the *Trade Union Law of PRC*.

³⁴⁶ Sina Finance, “On the Management’s Concurrent Post as the Trade Union Chairman” (从工会主席被炒谈经理人员兼职工会干部) (2004), available at <http://finance.sina.com.cn/review/20041109/12161142099.shtml>.

diminishes its actual function. To begin with, they may find themselves struggling to spare enough time and energy to trade union matters in addition to their daily management roles.³⁴⁷ A more severe problem will arise from their dual objectives. As senior managers, they are subordinate to the BoD and are obliged to implement its decisions. However, as chairman of the trade union, they are supposed to resist these decisions if they are contrary to the interests of the workers, but in such an event they tend to obey the decisions of the BoD because it has the power to change their occupational role, reduce their salaries, or even terminate their employment contract for reasons of serious negligence.³⁴⁸ Since “serious negligence” has not been defined by Chinese law, the BoD can use dismissal as a threat when the leaders challenge the BoD from the perspective of labour protection. For instance, the trade union chairman in a firm in Beijing was dismissed due to his negligence as a senior manager, but he claimed that his dismissal was attributable to the fact that he had reported the firm’s labour protection problems to the media in order to urge the firm to safeguard workers’ interests, which damaged the firm’s social image.³⁴⁹ As a result, the trade union chairman had to rely heavily on the BoD and the firm, thereby diluting the performance of the trade union in safeguarding labour interests.³⁵⁰

The second is that the trade union depends on the firm financially. According to the Trade Union Law, the funds of the trade union come from five sources: 1) membership dues paid by workers; 2) a monthly allocation from the firm, which should be equal to 2% of the employees’ overall wages; 3) income allocated by the enterprise to which the trade union is subordinated; 4) subsidies from the government; or 5) others.³⁵¹ The second and third sources come from the company and constitute the largest proportion of the trade union’s funds, whilst the money from the other sources is minimal.³⁵²

³⁴⁷ Liu & Zhang (n 344).

³⁴⁸ Article 18 of the *Trade Union Law of PRC*.

³⁴⁹ China News, “The First Dismissal of Trade Union Chairman in Beijing; Rights of Trade Union Cadres Attract Attention” (“北京首现工会主席被开除;工会干部权益引发关注”) (2017), available at <http://www.china.com.cn/chinese/2004/Sep/653208.htm>.

³⁵⁰ In a strike in southern China, the trade union was criticised for standing for the employer. Sina News, “Workers in Nanhai Toyota Return to Work: A Partial Victory For Workers” (南海本田复工：工人局部性胜利) (2017) available at <http://style.sina.com.cn/news/2010-06-03/094562469.shtml>.

³⁵¹ Article 42 of the *Trade Union Law of PRC*.

³⁵² X. Xu and Q. Wu, “Academic Analysis of the Nature and Characteristics, and the Core Functions of the Trade Union” (对中国工会性质特征和核心职能的学术辨析) (2011) 5 *Journal of Humanities* (人文杂志) 165 at 166.

Although the non-payment of trade union funds by the firm is against the law,³⁵³ this financial reliance on the firm will further reduce the independence of the trade union from the firm.

3.3.4 Conclusion

In conclusion, although the trade union seems to have extensive power to safeguard the interests of labour, its actual influence is weak, and the reasons can be summarised as follows:

In addition to the objective of safeguarding the interests of employees, the trade union is obliged to serve the interests of the party-state, which is attributable to the organisational structure of the trade union in the industrial relations system in China. Accordingly, the trade union cannot support workers when their interests conflict with those of the party-state.

The trade union cannot effectively challenge the BoD even when the interests of labour are damaged. This is because the trade union leaders normally hold concurrent positions in the firm as senior managers, making them subordinate to the BoD. The BoD has the power to decide their remuneration or even dismiss them, making the leaders of the trade union reluctant to express dissenting opinions.

3.4 Board Representation

Unlike the trade union and the Workers' Congress which can only participate in takeovers by management informing and consulting them, the representation of employees on the board of a firm provides a direct channel for workers to gain access to information and express their views on takeover decisions. According to Chinese laws, workers have the right to elect their representatives on the BoS as well as the BoD. Considering that reasons leading to their ineffectiveness are similar, this section focuses on the BoD for research purposes.

³⁵³ Article 43 of the *Trade Union Law of PRC*.

Since employee representation on the BoD is not required by Chinese laws, which are different from those governing the BoS, the popularity of employee directors is low.³⁵⁴ Such low popularity is also due to the notion that these employee representatives cannot effectively influence the management and operation of the company. We now turn to elaborate upon the various reasons in the discussion that follows.

In terms of their role on the BoD, the employee directors are clearly both the directors of the company as well as the employees.³⁵⁵ These representatives are in essence employees, so they are usually relegated to an inferior status compared to their colleagues on the BoD, who belong to the management team.³⁵⁶ Such employees tend to look up to the other directors in the hope of chances of promotion and salary raises.³⁵⁷ As the representatives of employees, they are elected to express workers' voices, whereas the directors hold the responsibility of maximising the interests of the company. The interests of employees cannot always align with the company's, rendering the employee directors' mission conflicted. There are scholars suggesting that the priority of the employee directors' job is to serve the best interests of the company, but concerning the issues directly relating to the interests of the employees, they should act as the representatives of the employees.³⁵⁸ However, considering employees' close connections with the company, it is impossible to differentiate between the interests of employees and those of the company, and this makes it challenging for the employee directors to strike a balance between their different roles.³⁵⁹

³⁵⁴ According to the survey conducted by the China Academy of Social Sciences, there are few employee directors in the top 100 listed companies in China. See Xinhua News, available at http://news.xinhuanet.com/fortune/2008-10/27/content_10257079.htm.

³⁵⁵ G. Hu, "The Flaws and Revision of the Employee Directors System in SOEs" (国有公司职工董事制度不足及其修正) (2010) 11 *Social Science (社会科学)* 95 at 96.

³⁵⁶ S. Kuruvilla, C.K Lee, and M.E. Gallagher, *From Iron Rice Bowl to Informalization: Markets Workers, and the State in a Changing China* (Cornell University Press-2011) 3.

³⁵⁷ J. Yi in a discussion chaired by H. Guo, "The Unexpected Employee Directors in SOEs" (变味的国企职工董事) (2011) 2 *Directors of Board (董事会)* 26, available at <https://finance.ifeng.com/leadership/yyq/20110215/3409216.shtml>.

³⁵⁸ J. Yi in Guo (n 357).

³⁵⁹ G. Hu (n 355) at 97.

In addition, the elected directors cannot effectively represent the interests of employees due to their close connection with the management and CPC committee of the firm. They are marked as the “noble employee directors” by Chinese scholars,³⁶⁰ since they rarely come from shop-floor employees of the company. Specifically, the candidates for the employee director role are nominated by the trade union,³⁶¹ and are normally designated as chairman or appointed to other senior positions in the trade unions by the CPC committee in the firm.³⁶² Therefore, such an election in the Workers’ Congress becomes a mere formality and cannot truly reflect the will of the workers. The chairman of the trade union, who is a member of the CPC committee (a detailed introduction to the CPC committee internal to the firm is made in section 4.3.1), normally holds a concurrent job in the management team. As a result, whether they can protect the interests of employees is highly doubtful if there is a conflict of interests.³⁶³ Admittedly, the representatives cannot and should not be from the workers on the shop-floor, since they are normally too anonymous to be elected by the Workers’ Congress whilst tending to be incompetent to deal with the management and operation of the company. However, considering that the firm is obliged to provide the employee directors with necessary training and services to help them perform their duties,³⁶⁴ the employees’ problems of incompetence can be solved to a large extent if such obligations of the firm can be performed effectively.

As mentioned above, employees can also perform supervision functions through their representatives on the BoS. As the main supervisory organ, the BoS can seldom function well, especially in the context of takeovers. This ineffectiveness is examined in Chapter 4, with a comparison to the German co-determination system.

³⁶⁰ Z. He in Guo (n 357).

³⁶¹ Article 38 of *Democratic Management Provisions*.

³⁶² Z. He in H. Guo (n 357). The employee directors are normally the chairman of trade union and may also include the senior management or CPC cadres.

³⁶³ H. Huang, “Thinking on the Employee Director System in SOEs” (关于在国有企业中设置职工董事制度的思考) (2011) 2 *Shanghai Lawyer* (上海律师), available at <http://www.lawyers.org.cn/info/2f44afedbd2047719b211c96be4d083f>.

³⁶⁴ Article 13 of *Regulations on the Performance of Responsibilities by Employee Directors on the Board of Directors in Central SOEs* (董事会试点中央企业职工董事履行职责管理办法) (2009).

3.5 To Resolve Chinese Problems by Legal Transplantation

This thesis attempts to solve Chinese problems in the context of hostile takeovers in the securities market by adapting German co-determination mechanism. This methodology is referred to as legal transplantation, which is a concept that describes “the moving of a rule or a system from one country to another, or from one people to another”.³⁶⁵ Chinese legislators have a tradition of transplanting many rules from different jurisdictions such as the UK, the US, and Germany to reform their own legal system, especially in commercial laws.³⁶⁶ Accordingly, this thesis holds that the most effective and efficient way to resolve Chinese problems in this context would be a legal transplantation, which is one of the most common ways in China for legal developments. However, legal transplantation remains controversial. Before introducing the German system to address Chinese hostile takeovers, it is necessary to examine the country argument.

To be specific, Legrand denied that the law is largely autonomous, instead stating, “the law lives in a profound way within a cultural-specific- and therefore contingent-discourse”.³⁶⁷ “There are degrees of transferability”,³⁶⁸ and the extent to which the law in a country is transferrable depends on the degree of its embeddedness in its national life.³⁶⁹ Therefore, if the legal system is rooted in a country’s specific contexts, legal transplantation is highly likely to fail, especially on condition that the social-political context are completely different between transplanting countries and receiving countries. Empirical observations supported this proposition. For example, Turkey adopting the Swiss Civil Code was rejected, at least in rural areas. Similarly, Islamic countries have difficulty in adopting western family laws, especially in terms of improving women’s status. In addition, even though the migration of legal rules is well adapted into the local legal system, their implementation may leave different

³⁶⁵ A. Watson, *Legal Transplant: An Approach to Comparative Law* (University of Georgia Press-1993) 21.

³⁶⁶ For instance, Chinese takeover rules adopted mandatory bid rules which originated in the UK.

³⁶⁷ P. Legrand, “The Impossibility of Legal Transplants” (1997) 4 *Maastricht Journal of European and Comparative Law* 111.

³⁶⁸ Kahn-Freund (n 15) at 6.

³⁶⁹ W. Ewald, “Comparative Jurisprudence (II): The Logic of Legal Transplants” (1995) 43 *The American Journal of Comparative Law* 489 at 495.

consequences from their origins, due to the divergence of social, cultural, and political contexts.³⁷⁰

This proposition is reasonable to an extent, as it identifies the difficulty in legal transplants. Specifically, there is a risk that the migrating rules cannot meet the lawmaker's expectation due to resistance from the domestic socio-political environment and the foreign rules' incoherence with the country's historical, cultural, and political backgrounds. However, this proposition does not constitute an obstacle in employing legal transplantation to solve problems in China, and the reasons are provided below.

First, legal transplantation, which is widely used in the context of legal convergence, positively affect national economies. The theory of legal transplants raised by Watson was largely based on observations. In other words, it had already been well accepted by legislators before the theory was initiated and debated, especially in the emerging economies. Legal transplantation, which is under the context of global legal convergence, can be traced back to Medieval *lex mercatorum*.³⁷¹ With the increase of cross-border transactions and the development of the global commercial and capital market, legal certainty and predictability are highly valued, and these virtues are perceived to enhance competition.³⁷² The wide use and introduction of commercial and corporate laws of western styles promote the convergence of the global legal system. In the long run, this convergence provides legal certainty and predictability in cross-border transactions, which tend to stabilize and strengthen national economies.³⁷³ Some countries may face difficulties in adapting foreign commercial or corporate laws into their domestic markets. However, it is expected to bring more benefits than harms to national economies, especially considering that legislators reserve the discretion to amend transplanted rules in their implementation. Rules can be modified according to the local environment and the change of circumstances.

³⁷⁰ M. Langer, "From Legal Transplants to Legal Translations: The Globalization of Plea Bargaining and the Americanization Thesis in Criminal Procedure" (2004) 45 *Harvard International Law Journal* 1.

³⁷¹ C.M. Schmitthoff, *Commercial Law in a Changing Economic Climate* (Sweet & Maxwell- 1981) 24.

³⁷² B.A. Markell, "A View from the Field: Some Observations on the Effect of International Commercial Law Reform Efforts on the Rule of Law" 6 *Indiana Journal of Global Legal Studies* 497.

³⁷³ L.A. Mistelis, "Regulatory Aspects: Globalization, Harmonization, Legal Transplants, and Law Reform- Some Fundamental Observations" (2000) 34 *International Lawyer* 1005.

Second, legal transplantation is one of the most convenient means of legal development and legal reform. There is no need to struggle to design a new rule by lawmakers to solve a problem because another country has already addressed such an issue.³⁷⁴ As discussed, the concern of the viability of this legal transplantation is raised due to the different social, political and economic context between countries. However, the problem can be alleviated to some extent due to improved international cooperation in modern times. In this context, “ideas and knowledge deriving from the positive or negative experience a legal system has made with regard to a statute”³⁷⁵ can be more effectively and thoroughly transferred to the host country in order to avoid problems. In addition, deeper international cooperation can help the recipient country draw advice from international agencies as well as experts. This can be exemplified by the United States Agency for International Development, which helped the former Soviet Union countries to establish the market-oriented judicial system.³⁷⁶ No legal system is perfect, but if a host country can continuously obtain technical assistance, the transplanted rules can be more readily adapted into the domestic contexts.

Third, the social, cultural, and economic environment of the host country is dynamic and not static. It is admitted that some foreign rules may be difficult to apply in with the domestic environment at the time of transplantation. However, it indeed helps or is expected to solve some problems that arise with legal and economic development. For instance, Japan imported directors’ fiduciary duty from US law in 1950³⁷⁷ and became orphaned for a long time “by the distinctive institutions characterizing Japan’s high economic growth period, which helped prevent the taking of corporate opportunities and other self-dealing by directors”.³⁷⁸ However, with the rise of takeovers in Japan, directors’ fiduciary duty could help restrict their improper conduct to reap large benefits in the change of control of the target firm. Therefore, whether

³⁷⁴ T.W. Waelde and J.L. Gunderson, “Legislative Reform in Transition Economics: Western Transplants- A Short-Cut to Social Market Economy Status” (1994) 43 *International & Comparative Law Quarterly* 347.

³⁷⁵ Mistelis (n 373) at 1064.

³⁷⁶ J. DeLisle, “Lex Americana: United States Legal Assistance, American Legal Models, and Legal Change in the Post-Communist World and Beyond” (1999) 20 *University of Pennsylvania Journal of International Economic Law* 179

³⁷⁷ Article 254-3 of *the Commercial Code of Japan* (1950).

³⁷⁸ H. Kanda and C.J. Milhaupt, “The Director’s Fiduciary Duty in Japanese Corporate Law” (2003) 51 *The American Journal of Comparative Law* 887 at 898.

imported rules are coherent with the local context should not be examined at the time of or immediately after transplanting. Instead, if they are compatible with the country's needs for development or are expected to exert positive impacts in the future, they still deserve to be imported.

Fourth, although the law cannot be isolated from its political, social, and cultural contexts, the law cannot be simply perceived as the result of a country's specific background. On the other hand, the domestic environment can also be largely shaped by legal reforms. This can be exemplified by the economic reform of 1980s in China, which started from a series of legal reforms.³⁷⁹ When the party-state decided to start the market-oriented economic reform, the cultural and social backgrounds in China made laws that aimed to encourage commercial activities unacceptable. Instead, they were more approving of the old planned economy before the reform. At the time, the party-state chose to transplant laws from the UK, the US, and Germany, which were ahead of China in terms of economic development. Although "reformers were eager to learn from foreign experience, they were unsure as to which model was suitable to China".³⁸⁰ Certain modifications were made to make the foreign rules adaptable for Chinese contexts, while these transplanted rules helped gradually establish the market mechanism in China.

Based on the analysis presented above, the contrary proposition to legal transplants cannot constitute an obstacle to introducing the German mechanism in China. On the other hand, it provides the inspiring insight that the legal transplantation should be careful, so the introduced system is accepted by the host country. Accordingly, this thesis provides three principles which the introduced co-determination regime should conform with. First, the imported rules should be compatible with the Chinese domestic environment. Considering that China is undergoing a great economic transition, the introduced system should be a particularly good fit for the Chinese economic system and its needs for development. Second, the German co-

³⁷⁹ D.C. Clarke, "What's Law Got to Do with It-Legal Institutions and Economic Reform in China" (1991) 10 *UCLA Pacific Basin Law Journal* 1.

³⁸⁰ L. Tan and J. Wang, "Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy" (2007) 7 *Journal of Corporate Law Studies* 143.

determination regime is able to effectively address workers' vulnerability in the firm as well as in the context of hostile takeovers. Third, it should be well adapted into the current corporate laws system. These principles are examined in the following chapters respectively. In Chapter 4, by comparing the economic system between China and Germany, the thesis presents that it is coherent with Chinese state capitalist system and fulfil China's demands for economic development. The German system's capability to improve workers' involvement in hostile takeovers is described in Chapter 5. In Chapter 6, the thesis attempts to make certain modifications to the German system, so it fits in with the Chinese current legal system.

3.6 Conclusion

The chapter discusses the ineffectiveness of the labour participation mechanism in takeovers, which in general lies in three aspects. First, the labour protection mechanism, especially the Workers' Congress, was embedded in the erstwhile Chinese planned economy, making it a challenge to adapt it to modern corporate governance mechanisms. Second, the role and function of employee participation institutions make employee representatives unable to uphold employees' claims against those of the party-state and the firm. The third aspect is attributable to the deficits of the legal framework. In particular, there are no explicit procedural rules or effective enforcement mechanisms to guarantee that workers' information and participation rights are adequately protected.

These problems provide insights on the direction of travel for the improvement of labour participation mechanisms in Chinese takeovers. First, the mechanism should fit in with the takeover process and work coherently with the major corporate organs in takeovers, including the BoD and the shareholder assembly. Second, these institutions should express the voice of workers, especially those from the establishment level, without yielding to those of the firm and the party-state. Accordingly, employee representatives should contain a significant proportion of shop-floor employees. Besides, they should not be exposed to risks such as a reduction in their earning capacity or being sacked for discharging their responsibilities towards employees.

Third, employees' voices should be effectively collected and valued by the management and the shareholder assembly. In order to achieve this objective, explicit procedural rules should be introduced to guarantee that workers are informed timely and thoroughly of a potential takeover. The takeover decisions should consider workers' opinions and be predictable and transparent for employees, and the management should be accountable for performing their obligations.

In order to resolve Chinese problems, the thesis attempts to transplant rules from German co-determination to Chinese firms. Before moving on to introduce the mechanism and examining its advantages in employee participation, a series of questions should be posed. First, why is this the German mechanism the most appropriate model chosen to be introduced? Second, considering that the introduction of German co-determination may lead to a different landscape of Chinese firms' ways of dealing with industrial relationships, is it coherent with the Chinese economic system? This thesis uses the varieties of capitalism (VoC) approach, which focuses on firms' ways of coordination with other economic actors, to justify the introduction of the German co-determination scheme to Chinese firms. Chinese firms share a high level of similarity with their German counterparts in their coordination with other firms, but their treatment of workers is distinct. This leads to institutional incoherence, which tends to negatively affect the Chinese economy. Therefore, it is plausible that the German co-determination mechanism is coherent with the Chinese economic system, and will positively affect the Chinese economy. In addition, it can help address the ineffectiveness of labour protection in the context of takeovers.

Chapter 4: Justifying the Introduction of the German Co-Determination Model: the VoC Approach

The idea of taking the German co-determination mechanism as a role model to improve employee protection in hostile takeovers in Chinese firms is inspired by the varieties of capitalism approach. Depending on how firms resolve coordination problems central to their competencies, political economies are divided into various types. Coordinated market economies (CME) and liberal market economies (LME) “constitute ideal types of a spectrum along which many nations can be arrayed”.³⁸¹ Due to the difference of social regulations, infrastructural institutions, political systems, culture, and history, the best practice of a specific kind of society may vary. Therefore, firms in different countries tend to display distinct strategies in industrial relations, including how workers are treated in takeovers. For instance, workers in CMEs, which are modelled on Germany, have broader and deeper participation in takeovers than those in LMEs, which are modelled on the US and the UK.

Despite its influential innovations in the field of political economy, the VoC approach finds it a challenge to accommodate the LME-CME value systems in the Chinese context.³⁸² Instead, China is carving its own path of exploring capitalism based on its indigenous political, cultural, and legal backgrounds, characterised as the state capitalist system. This refers to the economy where the government attempts to “meld the powers of the state with the powers of capitalism”.³⁸³ Although the Chinese path may be located beyond the VoC spectrum, the VoC approach can provide inspiring directions for China’s economic transformation, especially considering that there is no standard recipe for a country’s economic development.³⁸⁴ Compared to the LME, the Chinese state capitalist system seems to resonate more with the CME model, especially the German economy. Therefore, the German co-determination mechanism is highly likely to provide Chinese private firms in hostile takeovers with inspiring experience

³⁸¹ Hall and Soskice, *Varieties of Capitalism* (n 17) 8.

³⁸² T. Saich, *The Blind Man and the Elephant: Analysing the Local State in China* (Routledge-2009).

³⁸³ The Economist, “The Visible Hands” (2012)), available at <http://www.economist.com/node/21542931>.

³⁸⁴ M.K. Whyte, “Paradox of China’s Economic Boom” (2009) 35 *The Annual Review of Sociology* 371.

and is more likely to be fit into the Chinese economic system and to foster a robust Chinese economy.

This chapter begins with an introduction to the VoC approach, with an emphasis on the characteristics of the CME in Germany. This is followed by a comparison of the Chinese economic system with the German CME as well as the LME to show that the Chinese capitalist system shares more characteristics with the former. In the end, evidence is provided to show that the German co-determination system is compatible with the Chinese economic system and explains how the introduction of the former into China can be expected to have a positive impact on Chinese economic transformation.

4.1 An Introduction to the VoC Approach

The VoC approach to the political economy provides a framework for explaining institutional variations among different capitalist economies. This approach is based on the conception that a firm is relational, and therefore the firm's competency depends crucially on its ability to coordinate with a wide range of actors both internal and external to the firm.³⁸⁵ This firm-centred approach focuses on five spheres in which firms interact with other actors: industrial relations, vocational training and education, corporate governance, inter-firm relations, and relations with employees, three of which are related to coordination with employees. Different economies show distinct characteristics in resolving these coordination problems, and LMEs and CMEs lie at the poles of a spectrum, along which most nations can be plotted.

The key difference between CMEs and LMEs is that the former relies on non-market relationships to resolve coordination problems and construct their core competencies, whereas the latter do so via hierarchies and competitive market arrangements.³⁸⁶ Firms in CMEs access capital on terms that are relevant independent of fluctuations in profitability. Firms that are not sensitive to change in profitability tend to rely on a

³⁸⁵ Hall & Soskice, *Varieties of Capitalism* (n 17) 6.

³⁸⁶ Hall & Soskice, *Varieties of Capitalism* (n 17) 8.

strong labour force to achieve long-term returns on assets.³⁸⁷ Conversely, LMEs rely on highly competitive markets, and therefore the related labour markets are more fluid and maintained by formal employment contracts. In general, there are three aspects that reflect the differences between LMEs and CMEs in coordination with workers:

First, with regard to industrial relations, workers in CMEs tend to be organised and have a higher level of membership in trade unions. Bargaining over wages and working conditions tends to be at the industrial, sectoral, and national level. In contrast, workers in LMEs are less organised and wage negotiations are held at the company level and more individually. Second, given the strong support from labour organisations, workers in CMEs are expected to maintain long-term employment and therefore are inclined to cultivate firm or industry specific skills, while their LME counterparts are more likely to gain general skills that can be easily transferred to other jobs, since labour markets are comparatively fluid. Third, to ensure that employees coordinate well with others to improve the competencies of the firm, workers in CMEs have a deeper participation in corporate decisions, which can be exemplified by the German co-determination mechanism; this is rarely found in LMEs, where management are the major decision-makers.

The VoC approach has spawned influential accounts in the field of comparative political economy, albeit with certain limitations. First, the approach is limited by its “methodological nationalism”.³⁸⁸ To be specific, this approach tends to analyse economies statically, without adequately considering the impacts of global economic integration on restructuring capitalist systems in a particular nation. Second, it fails to “account for the pronounced interpenetration and mutual dependence of capitalist economies”.³⁸⁹ Third, it is preoccupied with limited, formal registers of institutional variety and accordingly unable to fully explain a new type of capitalism, including the Chinese model.³⁹⁰ However, it should be noted that by realising these limits the VoC

³⁸⁷ M. Aoki, “The Contingent Governance of Teams: Analysis of Institutional Complementarity” (1994) 35 *International Economic Review* 657.

³⁸⁸ J. Peck and N. Theodore, “Variegated Capitalism” (2007) 31 *Human Geography* 731.

³⁸⁹ J. Peck and J. Zhang, “A Variety of Capitalism with Chinese Characteristics” (2013) 13 *Journal of Economic Geography* 357.

³⁹⁰ N. Fligstein and J. Zhang, “A New Agenda for Research on the Trajectory of Chinese Capitalism” (2011) 7 *Management and Organization Review* 39.

approach is enriched and becomes more complicated. Consequently, this approach remains “a rich seam to mine, capable of accommodating new developments, and theoretically flexible enough to branch out into new arguments”.³⁹¹

Accordingly, although the Chinese state capitalist system is conceived as being located beyond the CME–LME continuum, analysing the Chinese system using the VoC approach is able to provide an inspiring direction for augmenting employee protection in hostile takeovers in China, more so during the current Chinese economic transformation. The next section examines the Chinese state capitalist system before comparing it with CMEs, which are modelled on German capitalism, as well as LMEs, which are modelled on the US and UK systems.

4.2 The Chinese State Capitalist System under the VoC Approach

China has scarcely been discussed under the VoC approach, which situation has mainly arisen from scholars’ debate over the specific variant of the economic system of China. Therefore, in this section, the Chinese economic system and its main features are first discussed, followed by a comparison of the Chinese economic system to the principal two models of the VoC approach.

Divergent views concerning the nature of Chinese capitalism arise from scholars’ different assessments of the weight of the importance of the party-state and market forces in the Chinese economy. For instance, some scholars contend that, given the grip of the party-state over the Chinese economy, the latter can hardly be considered as functionally capitalist.³⁹² Meanwhile, other researchers have recognised the positive role of private forces in the Chinese economic transformation,³⁹³ and therefore perceive it as a new-found variant of capitalism,³⁹⁴ or refer to the Chinese model as a

³⁹¹ B. Hancke, M. Rhodes, and M. Thatcher (eds), *Beyond Varieties of Capitalism: Conflict, Contradictions, and Complementarities in the European Economy* (Oxford University Press-2007) 9.

³⁹² M.W. Meyer, “Is it Capitalism” (2011) 7 *Management and Organization Review* 5.

³⁹³ N.R. Lardy, *Markets over Mao: The Rise of Private Business in China* (Peterson Institute for International Economics-2014).

³⁹⁴ G. Arrighi, *Adam Smith in Beijing: Lineages of the Twenty-first Century* (Verso-2008) 327.

“statist market economy”.³⁹⁵ This debate gradually came to an end when the expression “state capitalism” was coined by The Economist in 2012.³⁹⁶ The introduction of state capitalism identifies both the existence and significant roles of the party-state and the capitalist tool in the Chinese economy whilst leaving it open to continuing competition between the party-state and the private sector. In fact, although the party-state maintains its dominance in the Chinese economy, its attitudes towards the private sector determine the latter’s vitality. Therefore, an examination of the role of the party-state in the Chinese economy is key to understanding how private firms coordinate with other factors in China.

Concerning the state capitalist system in China, the party-state is firmly pushing forward market-oriented reform,³⁹⁷ which has made remarkable achievements.³⁹⁸ However, the party-state maintains its commanding heights,³⁹⁹ and therefore if the market fails to work, or works against the interests of the party-state,⁴⁰⁰ the party-state intervenes mainly through two mechanisms: 1) a high degree of direct participation in the economy, particularly through SOEs; 2) nondemocratic forms of public governance.⁴⁰¹ These two mechanisms and their impact on the private sector are discussed in the following subsection.

4.2.1 The State-owned Enterprises

SOEs refer to enterprises of which the state is the controlling shareholder. However, there is no generally agreed standard of what proportion of shareholding makes the state a controlling shareholder. But for the purposes of this research, relying on

³⁹⁵ The model emphasizes the goal of collective interests and social equality through extensive government intervention and state building for the restructuring of economics and politics. See D. Farnham, *The Changing Faces of Employment Relations: Global, Comparative and Theoretical Perspectives* (Red Globe Press-2015) 272.

³⁹⁶ The Economist, “The Rise of State Capitalism” (2012), available at <http://www.economist.com/node/21543160>.

³⁹⁷ The Central Committee of the CPC, *Decisions of Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform* (中共中央关于全面深化改革若干重大问题的决定) (2013).

³⁹⁸ China has become the second largest economy only after America.

³⁹⁹ Bremmer (338).

⁴⁰⁰ M.E. Gallagher, “The Social Relations of Chinese Capitalism”. (2015) in Liebman and Milhaupt (Eds.), *Regulating the Visible Hand* (n 135) 226.

⁴⁰¹ Liebman and Milhaupt (Eds.), *Regulating the Visible Hand* (n 135) xiv.

administrative policies, a company is an SOE if the state is the largest shareholder and its holding exceeds 30%.⁴⁰²

Generally, the State-owned Assets Supervision and Administration Commission (SASAC) of the central, provincial, or local governments performs the investors' functions and enjoys the investors' rights and interests on behalf of the state,⁴⁰³ making these companies and their subsidiaries SOEs.

In general, SOEs affect private firms in three ways. The first is through monopolies, especially considering that the SOEs are the mainstay of China's economy due to their robust role in the Chinese economy.⁴⁰⁴ Its monopolies are supported by the party-state and are widespread in major industries including the energy, mining, and infrastructure sectors.⁴⁰⁵ The second is through competition as well as partnership. With the implementation of the Chinese 'open-up' policy, private enterprises are being gradually allowed to access industries that were wholly state owned before. On the other hand, SOEs are attempting to penetrate the whole economy by acquiring private shares, which is one of the objectives of the mixed ownership reform. In this case, an increasingly intense public-private competition as well as broader public-private coordination are observed. It should be noted that neither the competition nor the coordination can be established on a fair basis, especially considering the party-state's grip on the Chinese economy through non-democratic regulations.

⁴⁰² According to Article 5 of the *Opinions on the Code of Conducts of the State Shareholder Exercising Shareholder Rights in the Joint Stock Company* (《股份有限公司国有股东行使股权行为规范意见》) (1997) (ineffective), on the condition that the state is the largest shareholder, it is the absolute controlling shareholder if its shareholding exceeds 50% while the relative controlling shareholder if its shareholding is between 30% and 50%. It is noted that a few other administrative departments such as the Ministry of Finance act as state shareholders.

⁴⁰³ Article 4 of the *State-owned Assets of Enterprises Law of PRC* (《中华人民共和国企业国有资产法》) (2008).

⁴⁰⁴ Although during the SOE reforms, the role of SOEs in the economy is declining, it still makes huge contributions to national GDP and tax revenues. See the statistics in A. Hu, X. Zhang, N. Gao, "SOEs: The Important Foundation of Safeguarding China's Financial Capability" (国有企业: 保证中国财政能力的重要基础) (2016) 2 *Journal of China National School of Administration* (《中国行政学院学报》) 19.

⁴⁰⁵ There are certain categories of industries that the government does not allow or only allows the private sector to enter if it has permission. See the State Council of PRC, *Opinions on Implementation of the System of the Negative List of the Market Access of the State Council* (《国务院关于实行市场准入负面清单制度的意见》) (2015) and Ministry of Commerce, *Draft of Negative List of Market Access (Experiment)* (《市场准入负面清单草案(试点版)》) (2016).

4.2.2 Non-democratic Public Governance

In addition to the ownership stake, the party-state can exert its influence over the market through regulatory and non-regulatory governance. The former is through administrative authorities. There are generally three relevant administrative bodies in the context of this paper, namely SASAC, CSRC, and the Ministry or Bureau of Human Resources and Social Security (HRSS). SASAC has the authority to oversee private firms wherein the party-state exerts control via a shareholding. CSRC is the department that regulates and supervises the capital market, including listed companies. HRSS has the responsibility to regulate the labour market, promote employment, and establish social security, and accordingly employee protection in private firms is under the supervision of the HRSS department.

These administrative organs may affect how private firms coordinate with other actors through regulatory governance, such as administrative approval, orders, or instructions. In the current round of reform, admittedly, the party-state plans to marketise the Chinese economy, and therefore regulatory administrative intervention in the economy is expected to reduce.⁴⁰⁶ However, given the party-state's dominant role, administrative intervention is expected to remain at a high level, and the minor reduction of regulatory governance is likely to be largely offset by non-regulatory governance.

In the non-regulatory field, proximity to the party-state will secure private firms' survival and prosperity. Since all the major banks in China are state-owned, firms with strong political connections will have a greater chance of receiving loans, possibly at a lower cost.⁴⁰⁷ In addition, firms with an intimate relationship with the party-state are more likely to obtain favourable government policies, such as tax reductions⁴⁰⁸ or subsidies.⁴⁰⁹ Such a close relationship with the party-state is mainly formed for two

⁴⁰⁶ The Central Committee of the CPC, *Decisions* (n 397). It should be noted that other evidence shows that this trend is expected to come to a halt, and this is discussed in a separate section.

⁴⁰⁷ C.K.W. Chow et al (n 340) at 367.

⁴⁰⁸ W. Cui (n 341) at 154.

⁴⁰⁹ Haley & Haley, *Subsidies to Chinese Industries* (n 342) 2. In 2015, 2752 listed companies obtained RMB 167.3 billion from the government, available at <http://news.xinhuanet.com/finance/2016-05/06/c128962597.htm>.

reasons. The first is the government's dependence on local firms for tax revenues and the execution of policy objectives. To be specific, tax revenues are an important criterion to assess the performance of the local government, while there are some policy objectives, such as increasing the volume of exports, which need solid support from the local companies. The second is the personal relationship between the management and government officials. Although the administrative organs have procedural rules on how to exercise their powers, "real authority in China is concentrated in the hands of political elites and is not subject to systematic monitoring by the public or politically independent institutions".⁴¹⁰ Therefore, a close relationship with the key figures in the government will enhance firms' intimacy with the government, thereby helping them avoid arbitrary administrative action.

As seen from afar, the party-state occupies the commanding heights of the Chinese economy and is able to affect private firms as well as other market actors through SOEs and its public governance. In the context of the VoC theory, private firms' relationship with the party-state can largely shape how they resolve coordination problems, and therefore is central to their competencies. In the next section, a detailed analysis of the Chinese capitalist system is made through the lens of the VoC, in order to identify why Chinese private firms can draw valuable lessons from the CME model of the German style.

4.2.3 An Analysis of the Chinese State Capitalist System through the VoC Lens

Explorations of the Chinese system have resulted in divergent conclusions. Witt holds that Chinese capitalism "looks more like an LME than a CME",⁴¹¹ while other scholars tend to compare the Chinese system with CME-like capitalism.⁴¹² Some think it more closely related to French capitalism.⁴¹³ All these scholars recognise the dominance of

⁴¹⁰ Milhaupt & Zheng (n 343) at 14.

⁴¹¹ M.A. Witt, "China: What Variety of Capitalism" (2010) *INSEAD Faculty & Research Working Paper 2010/88/EPS*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1695940.

⁴¹² P. Nolan, *Integrating China: Towards the Coordinated Market Economy* (Anthem Press-2007).

⁴¹³ Fligsten and Zhang (n 390).

the party-state in the Chinese economy, and this is the key point that makes it deviate from the typical model of either CMEs or the LMEs. However, it would be too hasty to reach any conclusion without a detailed analysis of how the political system, culture, and history affect the ways in which firms resolve coordination problems. Therefore, these previous works are unable to comprehensively describe the Chinese economic landscape. Striking a different path from these arguments, the analysis in this thesis suggests that the contemporary Chinese model shows characteristics of both poles of the VoC spectrum. To be specific, similar to the German style CMEs, Chinese firms rely more on non-market interactions among economic actors, and employers are geared towards information sharing. On the other hand, employees in Chinese firms are less organised due to the ineffectiveness of the trade union and the Workers' Congress, and the comparatively high turnover rates incline towards the LME model. It should be noted that in both CMEs and LMEs coordination at the levels of the employer and employees work in synergy. Therefore, the different styles in which Chinese firms interact with other firms (CME style) and with their employees (LME style) leads to a contradiction, which is detrimental to both the Chinese economy and the employees' interests.

Accordingly, CME and LME elements of the Chinese economy are identified in this section, before examining the negative effects of these contradicting styles on the Chinese economy and on workers in the private sector.

4.3 A Comparison of German CMEs and the Chinese Economy

CMEs tend to “provide companies with access to finance that is not entirely dependent on publicly available financial data or current returns”.⁴¹⁴ Financiers in CMEs tend to rely on private or inside information, which is relatively independent of fluctuations in profitability, with the objective of generating long-term returns. Therefore, access to this “patient capital” makes firms more likely to engage in research and development (R&D) as well as educating and training employees. Similar

⁴¹⁴ Hall & Soskice, *Varieties of Capitalism* (n 17) 22.

characteristics can be found in the Chinese economy, where share prices do not entirely reflect firms' financial reality and firms' long-term returns are valued. The conclusion is inescapable that both types of economies' deviation from an entirely market-oriented mechanism is due to their dependence on dominant forces other than dispersed institutional investors as in the LMEs. The difference is that the market in Germany is bank-led, whereas the Chinese system is state-led. Although the party-state in China functions differently from banks in Germany, Chinese firms tend to value more their long-term returns under its leadership, which is similar to their German counterparts' experience under banks' leadership.

Given the lower level of dependence on publicly available information, better forms of private information sharing between economic actors, especially firms and their financiers, should be established in CMEs. In Germany, financiers' access to firms' information is through cross-shareholdings and joint membership in industrial associations, as well as managers' and technical personnel's personal relationships with counterparts in other companies. The first emphasises the firms' shareholding interactions with other economic actors; the second refers to institutional interaction, whilst the third type of coordination is through interpersonal relationships. In this sense, Chinese private firms share a high degree of similarity with their German counterparts. However, due to the different political and historical backgrounds, these mechanisms are less effective in the Chinese market in terms of coordination among economic actors. Instead, there are other mechanisms unique to the Chinese economy, such as the party-state internal to the firm and the *guanxi* networks.

Accordingly, the comparison of the Chinese and the German economies lies in two aspects. First the dominant forces, namely banks in Germany and the party-state in China, are examined, with an emphasis on their similarities and differences in fostering national economic performance. The second aspect is an investigation of the shareholding, institutional, and interpersonal ways of coordination in the Chinese and the German economies.

4.3.1 The Dominant Forces in the German and Chinese Economies

There is widespread agreement that commercial banks in Germany are able to substantially coordinate economic activities throughout the nation. There are three institutional sources for major banks to exercise “influence over firms to help coordinate decisions and relations between them”.⁴¹⁵ First, major banks in Germany have extensive shareholdings in industry. The level of bank control is somewhat exaggerated due to prevalence of the proxy-voting system,⁴¹⁶ which enables banks to vote through far more shares than they have direct ownership of.⁴¹⁷ For instance, as Nibbler observes, three major banks in Germany—Deutsche, Dresdner, and Commerzbank—owned 6.8% of the equity of their own shares, but the average size of proxies was 17.6%.⁴¹⁸ Second, these bank shareholders can exert control over corporate management through shareholder seats on the corporate supervisory board, which monitors the decision-making of the management board and managerial performance. Even in firms where half of the supervisory board is constituted of employee representatives, the chairman of the board is elected by shareholders, over whom bank shareholders have substantial influence, with a casting vote in the event of a tie in decision making. Third, financing in Germany is bank-based, where bank loans account for a large proportion of firms’ liabilities. This is distinct from the market-based economy in other countries, especially the US, which is characterised by strong and fluid capital markets.⁴¹⁹ Firms’ heavy reliance on bank finance shields corporate managers from short-term imperatives driven by equity investors’ demands.⁴²⁰ This in turn strengthens the banks’ oversight of corporate managerial behaviour.

⁴¹⁵ R. Deeg, “The State, Banks, and Economic Governance in Germany” (1993) 2 *German Politics* 149.

⁴¹⁶ This refers to the situation when bank shareholders delegate their representatives to vote on behalf of them.

⁴¹⁷ J. Franks and C. Mayer, “Ownership and Control of German Corporations” (2001) 14 *The Review of Financial Studies* 943

⁴¹⁸ M. Nibler, “Bank Control and Corporate Performance in Germany: The Evidence” (1998). *PhD Dissertation Cambridge University*.

⁴¹⁹ S. Vitols, “Changes in Germany’s Bank-Based Financial System: A Varieties of Capitalism Perspective” (2004) *Discussion Paper SP II 2004 Wissenschaftszentrum Berlin*, available at <https://www.econstor.eu/bitstream/10419/51230/1/38574787X.pdf>.

⁴²⁰ P.D. Culpepper, “Institutional Change in Contemporary Capitalism: Coordinated Financial Systems since 1990” (2005) 57 *World Politics* 173.

A similar pattern can be found in China in terms of the party-state's ways of influencing firms' coordination activities. First, the party-state has extensive shareholdings in Chinese industries, including both the state and private sector. For instance, the party-state indirectly owns shares through state agencies, such as SASAC of the central, provincial, or local governments, and the Ministry of Finance.⁴²¹ On behalf of the state, these agencies perform investors' functions and enjoy the investors' rights and interests,⁴²² in addition to supervising these firms and their subsidiaries as supervision administration and regulator. These state-owned enterprises are the mainstay of China's economy due to their robust role in the Chinese economy⁴²³ and their monopolies in major industries including the energy, mining, and infrastructure sectors.⁴²⁴ The party-state extended its share ownership to the private sector by initiating the mixed ownership reform in 2015, which encourages the party-state to invest in private firms that are perceived as promising.⁴²⁵ Second, similar to German banks, the party-state in China can participate in and supervise corporate management, albeit not through representatives they directly appoint. The party-state engages in corporate affairs through the CPC committee internal to the firms, which is unique to the Chinese context. According to the constitution of the Communist Party of China (CPC), a party organisation⁴²⁶ should be formed within an entity if there are at least three members of the CPC.⁴²⁷ Therefore, considering the large number of party members in China,⁴²⁸ a CPC committee exists in almost every private firm. The role of the party-state in a private firm can be seen in diagram 3. It should be noted that these party-state organisations are not corporate governance organs, and their responsibility is not to engage in corporate management. However, members in the

⁴²¹ Generally, non-financial SOEs are under the purview of the SASAC at different levels whilst the Ministry of Finance acts as the state agency in financial SOEs.

⁴²² Article 4 of the *State-owned Assets of Enterprises Law*.

⁴²³ Although during the SOE reforms, the role of SOEs in the economy is declining, it still makes huge contributions to national GDP and tax revenues. See the statistics in Hu et al (n 404).

⁴²⁴ There are certain categories of industries that the government does not allow or allow only the private sector to enter subject to permission. See the State Council (n 389) and Ministry of Commerce (n 405).

⁴²⁵ The State Council, *Opinions of the State Council on the Development of Mixed-ownership Economy* (《国务院关于国有企业发展混合所有制经济的意见》) (2015).

⁴²⁶ Article 6 of *Organisational Regulation of CPC on Grass-roots Work in Organs of the Party and Government* (《中国共产党党和国家机关基层组织工作条例》) (2010).

⁴²⁷ Article 29 of *The Constitution of the CPC of China* (《中国共产党党章》) (2012).

⁴²⁸ As of 2015, the membership of the CPC exceeded 88 million. See *Statistical Bulletin of CPC in 2015* (2015 年中国共产党党内统计公报), available at <http://cpc.people.com.cn/n1/2016/0701/c404684-28514117.html>.

CPC committee are deemed as key personnel of the firm, since they normally hold concurrent positions in the senior management teams. Therefore, they may have easy access to private firms' financial statements, which provides an important channel for the party to monitor firms.⁴²⁹

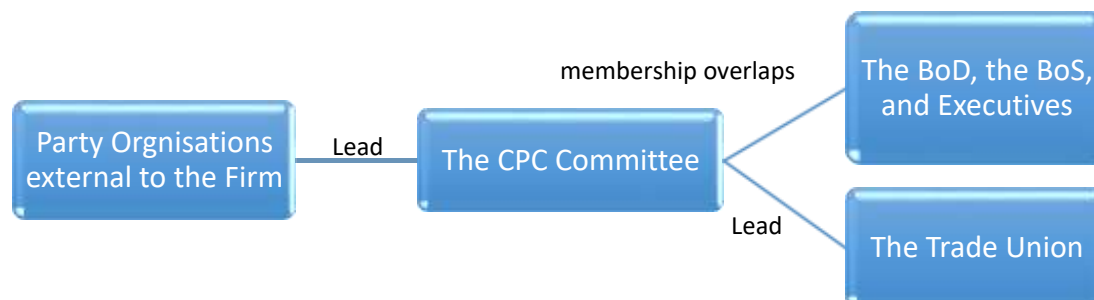


Diagram 3: the role of the CPC committee in Chinese firms

Moreover, private shareholders and senior management are not able to dispose of this supervision by dismissing their party leader, since that is the prerogative of the party-state. Third, firms with close political connections in China have a better chance of securing funds. Firms' connections with the party-state play an important role in explaining firms' financial condition, especially considering the extent of misallocation of credit by dominant state-owned banks.⁴³⁰ Further evidence shows that party membership can help private firms to obtain loans from banks or other financial institutions.⁴³¹ In addition, Chinese firms with strong political connections run a lower risk of rejection of their initial public offerings (IPO), and are observed to perform better subsequent to their IPOs.⁴³² This is mainly due to the party-state's leadership of the China Securities Regulatory Commission and stock exchanges. Due to the deviation of the stock market from the market mechanism, empirical studies show that there is no observable relationship between the stock market and the real economy.⁴³³

⁴²⁹ W. Shi, L. Markoczy and C.V. Stan, "The Continuing Importance of Political Ties in China" (2014) 28 *The Academy of Management Perspectives* 57 at 63.

⁴³⁰ R. Cull, W. Li, and W. Li, "Government Connections and Financial Constraints: Evidence from a Large Representative Sample of Chinese Firms" (2015) 32 *Journal of Corporate Finance* 271.

⁴³¹ H. Li, L. Meng, Q. Wang, and L. Zhou, "Political Connections, Financing and Firm Performance: Evidence from Chinese Private Firms" (2008) 87 *Journal of Development Economics* 283.

⁴³² X. Bao, S. Johan, K. Kutsuna, "Do Political Connections Matter in Accessing Capital Markets? Evidence from China" (2016) 29 *Emerging Markets Review* 24.

⁴³³ L. Pan and V. Mishra, "Stock Market Development and Economic Growth: Empirical Evidence from China" (2018) 68 *Economic Modelling* 661.

Instead, Chinese stock markets are policy oriented, tending to react actively to changes in administrative policies.⁴³⁴ Therefore, being better informed about and prepared for policy changes is key to stabilising and improving share prices, the precondition for which is a sound relationship with the party-state. In this sense, Chinese firms depend more extensively and deeply on the party-state in financing, compared to their German counterparts who depend on the banks.

Both German and Chinese economies have dominant forces—banks and the party-state respectively—leading to a high degree of similarity in firms’ coordination activities. First, firms’ affiliation with the dominant forces improves their competency. This arises from banks’ and the party-state’s extensive shareholdings as well as their participation in corporate management, and from their decisive say over firms’ financing. Second, firms’ reliance on banks and the party-state in Germany and China, respectively, makes corporate managers shy away from being pressured for short-term gains and focus instead on their firms’ long-term value, especially considering the weak functioning of the stock market in both economies.

At the same time, it should be noted that the Chinese state-led economy displays certain differences from the German bank-led economy. To be specific, the party-state has a more extensive and deeper impact on the Chinese economy and private firms than banks in Germany. The grip of the party-state makes the state’s political objectives one of the most important considerations in Chinese corporate management. In addition, the different ways of influencing private firms in the two systems lead to different patterns of firms’ coordination activities, and this is illustrated in the following three sections.

4.3.2 Cross-Shareholdings Among Firms

⁴³⁴ Y. Wang, J. Tsai, and Q. Li, “Policy Impact on the Chinese Stock Market: From the 1994 Bailout Policies to the 2015 Shanghai-Hong Kong Stock Connect” (2017) 5 *International Journal of Financial Studies* 4.

Cross-shareholding refers to situations in which two or more firms each hold shares in the others. In German CMEs, “dense networks of cross-shareholding”⁴³⁵ are commonly used to facilitate the sharing of information and resources as well as strengthen long-term coordination among different firms. These ownership collaborations also make hostile takeovers difficult to execute,⁴³⁶ thereby enabling corporate managers to focus on long-term interests that deviate from the stock price maximisation path.⁴³⁷

In comparison, cross-shareholdings in Chinese private firms follow different paths since their development is generally guided by the party-state. The cross-shareholding arrangements in the Chinese market emerged much later than in the German market. The emergence of the development of cross-shareholdings in China dates back to 1986.⁴³⁸ These shareholding arrangements were introduced in the context of the state-owned enterprise reform and aimed to diversify the concentrated shareholding pattern caused by the dominance of the party-state.⁴³⁹ Cross-shareholdings are a strategy commonly used by state-owned enterprises to evade the minimum registered capital legal requirement for a firm’s initial public offerings, especially considering that most firms were short on capital at the early stages of the Chinese economic reform. This is because the equities of each firm may be counted twice in a cross-holding arrangement,⁴⁴⁰ enabling state investors to use fewer funds for more registered capital. The second milestone of the cross-shareholding structure was the mixed-ownership reform started in 2005. This reform marketizes state-owned enterprises by attracting private strategic investors and also boosts the private economy by investing state capital in private firms. Accordingly, cross-holdings are one of the most effective arrangements to achieve both these objectives and are, therefore, encouraged by the

⁴³⁵ P. Hall and D. Gingerich, “Varieties of Capitalism and Institutional Complementarities in the Political Economy” (2009) 39 *British Journal of Political Science* 449.

⁴³⁶ T. Jenkinson and A. Ljungqvist, “The Role of Hostile Stakes in German Corporate Governance” (2001) 7 *Journal of Corporate Finance* 397.

⁴³⁷ H. Odagiri, *Growth through Competition, Competition through Growth: Strategic Management and the Economy in Japan* (Oxford University Press-1992).

⁴³⁸ D. Faure, *China and Capitalism: A History of Business Enterprise in Modern China* (Hong Kong University Press-2006) 86.

⁴³⁹ The State Council of PRC, *Suggestions on Deepening Corporate Reform and Strengthening Corporate Management* (治理整顿中深化企业改革强化企业管理的意见) (1990).

⁴⁴⁰ H. Bierman and N.H. Noyes, “Total Stock Market Value with Reciprocal Ownership: A Note on the Japanese Situation” (1990) 46 *Financial Analyst Journal* 77.

party-state.⁴⁴¹ It should be noted that cross-shareholding is a commonly used technique by the party-state to achieve its objectives, but the private sector shows a different pattern.

Cross-shareholdings were established much later in private firms than in the public sector. They are prevalent in the Chinese capital market, usually to strengthen firms' collaboration activities.⁴⁴² However, their development remains at an early stage, and a series of problems tend to arise. First, due to double counting, cross-shareholdings may result in inflated registered capital and hurt interests of investors.⁴⁴³ Second, such interlocked ownerships among firms may "foster a moral hazard among incumbent managers (insider control)", which normally results in "low performance due to either over-investment or low effort levels in relation to capital and labour input".⁴⁴⁴ Third, strategic alliances between firms in the same industry may also lead to a monopoly. Accordingly, the party-state takes a cautious attitude towards the development of cross-shareholdings. For instance, cross-shareholdings between listed firms and their subsidiaries are forbidden by two major stock exchanges in China.⁴⁴⁵ It should be noted that these rules constitute the party-state's first attempt to regulate firms' cross-shareholding arrangements. Compared to the German market which has detailed regulations on such equity linkages,⁴⁴⁶ the party-state and Chinese economy are not fully ready to cope with complex situations during the enforcement of cross-shareholdings, especially in private firms where the party-state does not have direct shareholding control. Hence, further measures to regulate cross-shareholding

⁴⁴¹ The Central Committee of the Communist Party of China and the State Council, *Guide Opinions of Central Committee of the Communist Party of China and the State Council on Deepening the SOE Reform* (中共中央、国务院关于深化国有企业改革的指导意见) (2013).

⁴⁴² For instance, in the announcement of Changrong Ltd on 23rd Jan, its cross-shareholdings with Heidelberger Druckmaschinen AG is to strengthen their collaboration, available at <http://www.cninfo.com.cn/new/disclosure/detail?plate=&orgId=9900017111&stockCode=300195&announcementId=1205796311&announcementTime=2019-01-23%2012:34>.

⁴⁴³ X. Wang, J. Song, and C. Deely, "Research on the 'Doubled-Edged Sword Effect' of Cross-shareholdings in China" (2012). *International Conference on Engineering and Business Management Papers* 190, available at https://file.scirp.org/pdf/EBM2012_2013041710425939.pdf.

⁴⁴⁴ H. Miyajima, "The Unwinding of Cross-shareholding in Japan: Causes, Effects, and Implications" in M. Aoki, G. Jackson, and H. Miyajima (eds), *Corporate Governance in Japan: Institutional Change and Organizational Diversity* (Oxford University Press-2007) 108.

⁴⁴⁵ Article 11.9.5 of *Listing Rules of Shanghai Stock Exchange* (上海证券交易所股票上市规则)(2019) and Article 11.8.4 of *Listing Rules of Shenzhen Stock Exchange* (深圳证券交易所股票上市规则) (2019).

⁴⁴⁶ See Article 328 of the *German Stock Corporation Act* (2016).

arrangements can be expected, which may hinder their development and use in the Chinese economy.

In conclusion, similar to German firms, cross-shareholdings in Chinese firms play a significant role in both the private and public sectors. However, unlike their German counterparts, the cross-shareholdings in Chinese firms cannot play a significant role in the firms' coordination as the development of cross-shareholdings remains at an early stage. In addition, considering the unpredictability of the party-state in solving problems that arise from these arrangements, private firms tend to avoid or be prepared for a change in their shareholding structures at any time,⁴⁴⁷ which is time-consuming and costly.

4.3.3 Institutional Coordination

An institutional method of coordination is through a business or employers' association. This method was one of the key components that led to Germany's post-war economic success.⁴⁴⁸ Although evidence shows a downward trend in the membership of German institutions from the 1990s,⁴⁴⁹ the employers' association maintains a pivotal role in various spheres of the German economy. In general, the contributions of business associations can be categorised as market-supporting and market-complementing activities.⁴⁵⁰ The former refers to business associations pushing underperforming states to provide public goods while the latter emphasises the associational behaviours that facilitate the coordination of economic actors. Accordingly, this section focuses on the latter. To ensure these associations function effectively, they have been granted certain governance powers, "with the state awarding its outcome legally binding status".⁴⁵¹ In general, the functions of these

⁴⁴⁷ Sina Finance, "Modification of Listing Rules of Shanghai and Shenzhen Stock Exchange: New Rules on Cross-Shareholdings" (沪深交易所再改上市规则 交叉持股有规可依了) (2019), available at <https://finance.sina.com.cn/stock/hyyj/2019-04-30/doc-ihvhiqax6020276.shtml>.

⁴⁴⁸ L. Turner, *Democracy at Work: Changing World Markets and the Future of Labor Unions* (Cornell University Press-1991) 235.

⁴⁴⁹ S.J. Silvia, "German Unification and Emerging Divisions within German Employers' Associations: Cause or Catalyst?" (1997) 29 *Comparative Politics* 187.

⁴⁵⁰ R.F. Doner and B.R. Schneider, "Business Associations and Economic Development: Why Some Associations Contribute More than Others" (2000) 2 *Business and Politics* 261.

⁴⁵¹ W. Streeck, "German Capitalism: Does it Exist? Can it Survive?" (1997) 2 *New Political Economy* 237.

institutions are based on the following two aspects. First, joint membership in these institutions enables the sharing of information and subsequently facilitation technological improvements, standard settings, and vocational training.⁴⁵² Any free-rider or opportunistic behaviours are monitored by the associations and sanctioned with a loss of reputation.⁴⁵³ Actors with low reputations tend to be deterred from further participation in business associations, which substantially reduces their competency. Second, these firms have the right to establish or join employer associations that represent employers in collective bargaining negotiations with employees represented by trade unions.⁴⁵⁴ This is not discussed in detail in this section as it does not closely relate to coordination among firms.

The activities of Chinese business associations show patterns similar to their German counterparts in improving firms' coordination, albeit with certain differences that are mainly caused by the leadership of the party-state. Chinese scholars have reported that these organisations substantially impact Chinese firms' coordination⁴⁵⁵ and help their members engage in vocational training, new business exploration, technology production and improvement, and brand promotion. In addition, these institutions promote collaborative activities among their members. Chinese firms do not show a fair amount of enthusiasm for participating in the activities of these organisations, as is evidenced by a low ratio of membership fee payment.⁴⁵⁶ This is because the establishment of almost all the Chinese business associations are led by the party-state, leading to disorganised administrative and associational functions. For instance, the key personnel of these organisations hold concurrent administrative positions while their funds are allocated by the government; therefore, these organisations are normally perceived as branches of the government.⁴⁵⁷ As a result, Chinese business

⁴⁵² A. Ebner, "Varieties of Capitalism and the Limits of Entrepreneurship Policy: Institutional Reform in Germany's Coordinated Market Economy" (2010) 10 *Journal of Industry, Competition, and Trade* 319.

⁴⁵³ R. Whitley, *Business Systems and Organizational Capabilities: The Institutional Structuring of Competitive Competences* (Oxford University Press-2007) 184.

⁴⁵⁴ A. Hassel, "What Does Business Want? Labour Market Reforms in CMEs and Its Problems" in B. Hancke, M. Rhodes and M. Thatcher (eds), *Beyond Varieties of Capitalism* (Oxford University Press-2007) 253.

⁴⁵⁵ J. Yu, Y. Shen, and J. Zhou, "The Support of the Government and the Impacts of Business Associations on the Economic Transformation: Empirical Studies on Zhejiang Province, Jiangsu Province, and Shanghai" (政府支持与行业协会在经济转型升级中的作用：基于浙江省、江苏省和上海市的研究) (2013) *The Journal of Shanghai Administration Institute* (上海行政学院学报) 4.

⁴⁵⁶ J. Yu et al (n 455).

⁴⁵⁷ J. Yang, "Legal Analysis of the Ineffectiveness of the Work of Business Associations" (行业协会运行阻却的法

associations tend to represent the interests of the party-state rather than those of business or industry as a whole, attenuating their active participation in the activities. Realising this problem, the party-state plans to reduce its intervention by removing the organisations' administrative and financial affiliations to the government.⁴⁵⁸ However, the party-state would retain its control over these organisations via the CPC committee. Therefore, while the impact of the party-state on the work of business associations is expected to become weaker, the former will retain its decisive say. Therefore, these organisations can hardly play as active a role in the firms' coordination as their German counterparts. In addition to the coordination function, industrial associations in China similarly represent the employer group in collective bargaining.⁴⁵⁹ However, this function is perceived as formalistic for two reasons. First, as mentioned above, these associations struggle to represent the employers' interests due to the presence of strong administrative intervention. Second, the trade unions which are supposed to bargain in favour of the interests of the workers are also under the leadership of the party-state. Therefore, in the collective bargaining process, both the parties endeavour to reach an agreement in a timely manner and at low cost, rather than speak up for the groups they represent.

Compared to the institutionalised method of cooperation among German firms, Chinese private firms have an effective approach to coordination through their internal CPC committees, as mentioned above. These CPC committees show high-level integration and collaboration as they are all under the leadership of the party-state. The party-state provides various platforms to connect these party-state committees, including meetings or training sessions organised for their cadres. Accordingly, these party members are obliged to share information with the government and colleagues in other firms to ensure that the market, as a whole, works in compliance with the policies and guidelines of the party-state. Considering the party-state's level of authority in the Chinese economy, these party organisations provide direct and

律因素分析) (2017) 3 *Exploration Zone (探索带)* 248.

⁴⁵⁸ General Office of the State Council of PRC, *Plans on Cancelling the Affiliation of the Business Associations to the Administrative Institutions (行业协会商会与行政机关脱钩总体方案)* (2015).

⁴⁵⁹ J. Zhang and W. Xu, *Case Analysis of Collective Bargaining in Workers' Wages (工资集体协商典型案例分析)* (China Workers Publishing House-2014).

effective ways of coordination compared to industrial associations. However, whether such involuntary collaborations comply with the firms' economic interests is doubtful as, occasionally, their economic interests would be subject to political objectives such as safeguarding national security and sovereignty.⁴⁶⁰ For instance, overseas investments in Chinese firms in industries of information and communication technology are restricted by the party-state,⁴⁶¹ which may be opposed to these firms' interests but compatible with the objective of safeguarding national security.

In conclusion, Chinese employers' associations function in ways similar to their German counterparts, but their role in the Chinese market is much weaker. The core reason is the intervention of the party-state which makes these so-called "civil associations" indistinguishable from administrative organs. Therefore, these business associations can hardly represent the employers' interests, especially when there are conflicts of interest with the party-state. This attenuates the firms' enthusiasm to coordinate with one another through their business associations. In addition to the institutional cooperation approach prominent in Germany, Chinese firms can cooperatively work with other economic actors through their internal CPC committees but not exclusively for their economic interests. Occasionally, they would be subject to the party-state's political objectives, which is frequently observed under the Chinese state capitalist system.

4.3.4 Interpersonal Relationships in the Economy

The dense interpersonal networks linking "the managers and key technical personnel inside a company to their counterparts in other firms"⁴⁶² facilitate the firms' process of information sharing with other economic actors. Such interpersonal relationships are cultivated based on trust. Trust is defined as a set of expectations that other people

⁴⁶⁰ China News, "The First Round of the Dialogue between China and the US: All Major Issues Discussed except Moon Landing" (首轮中美经济对话:除上月球外主要问题均已谈及) (2009), available at <http://www.chinanews.com/qn/news/2009/07-29/1794984.shtml>.

⁴⁶¹ Ministry of Commerce, *Catalogue for the Guidance of Foreign Investments Industries* (外商投资产业指导目录) (2017).

⁴⁶² Hall & Soskice, *Varieties of Capitalism* (n 17) 23.

cares and can be believed in imperfectly defined future situations.⁴⁶³ In Germany, interpersonal coordination methods are prevalent in small firms, where “firms seem to cooperate without formal contracts or backup from a well-functioning legal system”.⁴⁶⁴ Such interpersonal relationships are also valued in large firms since mutual trust among the key personnel enables the development and operation of shareholding and associational arrangements through information sharing and other forms of collaboration.⁴⁶⁵ Any opportunistic or miscreant behaviours may cause a breakdown of interpersonal trust, which disrupts the reputation of reliability and negatively affects the institutional and shareholding networks. Therefore, although interpersonal relationships are prevalent in the German economy, they function as supplements for shareholding and institutional coordination.⁴⁶⁶ It should be noted that levels of interpersonal trust vary in different countries.

Coordination among Chinese firms particularly relies on *guanxi*, i.e. interpersonal connections rooted in Chinese traditional culture. It is “based implicitly (rather than explicitly) on mutual interest and benefit. Once *guanxi* is established between two people, each can ask a favour of the other with the expectation that the debt incurred will be repaid sometime in the future”.⁴⁶⁷ *Guanxi* networks serve as a form of social currency which enables corporate managers to gain access to scarce information, resources, and even favourable treatment.⁴⁶⁸ Unlike the German market where interpersonal relationships mainly function through inter-firm cooperation, *guanxi* networks also connect private firms with the party-state, which is essential for business success in the Chinese economy.

⁴⁶³ H. Farrel, *The Political Economy of Trust Institutions, Interests, and Inter-Firm Cooperation in Italy and Germany* (Cambridge University Press-2009) 24.

⁴⁶⁴ H. Farrel, *The Political Economy* (n 463) 65.

⁴⁶⁵ R. Dahlstorm and A. Nygaard, “An Exploratory Investigation of Interpersonal Trust in New and Mature Market Economies” (1995) 71 *Journal of Retailing* 339.

⁴⁶⁶ L.G. Zucker, “Production of Trust: Institutional Sources of Economic Structure, 1840-1920” (1986) 8 *Research in Organizational Behavior* 53

⁴⁶⁷ M.M. Yang, *Gifts, Favors and Banquets: The Art of Social Relationship in China* (Cornell University Press-1994) 1.

⁴⁶⁸ A.S. Tsui, J.L. Farh, and K.R. Xin, “Guanxi in the Chinese Context” in J.T. Li, A.S. Tsui, and E. Weldon (eds), *Management and Organizations in the Chinese Context* (Palgrave Macmillan-2000) 225.

According to an observation by the *Poulson Institute*, “Although China has many law-making institutions and procedures that resemble those typically found in developed markets, real authority in China is concentrated in the hands of political elites and is not subject to systematic monitoring by the public or politically independent institutions”.⁴⁶⁹ This highlights the significance of private firm managers’ relationships with these political elites with real power for personal gains or to better firm performance. This is because the latter are able to decide how they supervise, regulate, or facilitate corporate businesses and management. Evidence shows that entrepreneurs in the private sector with strong political connections enhance their firm’s performance “in terms of sales, number of employees, and equity value”.⁴⁷⁰ *Guanxi* can be established with the party-state elites through various ways. First, strong connections can be developed with officials who have worked in SOEs or even the government. For example, Wang Shi, the founder and chairman of Vanke, the largest real estate developer in China, served the Guangdong provincial government before starting his own business. Second, some SOEs get transformed into private forms during SOE reforms, which was the case with Ping An Insurance, and therefore the management’s political ties with officials are inherited and maintained. Third, the representatives of the People’s Congress and members of the Chinese People’s Political Consultative Conference are usually leaders of private firms, including board chairpersons or managers, and the abovementioned two institutions work closely with the party-state,⁴⁷¹ which provides them with abundant opportunities to socialise with government officials.

It should be noted that *guanxi* networks also prevail in inter-firm relationships, especially because they are considered as integral parts of people’s lives, particularly their business lives.⁴⁷² *Guanxi* can be established through shared aspects such as

⁴⁶⁹ Milhaupt & Zheng (n 343) at 14.

⁴⁷⁰ D. Guo, K. Jiang, B. Kim, and C. Xu, “The Political Economy of Private Firms in China” (2014) 42 *Journal of Comparative Economics* 286.

⁴⁷¹ The People’s Congress is the organ of power in China, which regulates and supervises the government whilst Chinese People’s Political Consultative Conference is normally for people in other parties to express their opinions, discuss and suggest on national and civil affairs. See *The Constitutional Law of People’s Republic of China* (《中华人民共和国宪法》) (2018).

⁴⁷² S. Lovett and L.C. Simmon and R. Kali, “Guanxi versus the Market: Ethics and Efficiency” (1999) 30 *Journal of International Business Studies* 231.

family backgrounds, place of origin, experiences, educational affiliation, and other dimensions.⁴⁷³ A firm is more likely to establish sound collaborations with other economic actors who have good personal relationships with key personnel in the firm. Trust at the personal level can be transferred to the organisational level.⁴⁷⁴ For instance, in knowledge-intensive industries, *guanxi* can be cultivated through knowledge and information exchanges, which further strengthen the firm's alliances.⁴⁷⁵ In addition, although the patron–client exchange is generally subject to the market, better personal relationships tend to facilitate the exchange of goods and services.⁴⁷⁶

Compared to Germany, interpersonal relationships play a highly significant role in the Chinese economy. Some argue that this is because the Chinese market lacks a stable legal and regulatory environment that allows for impersonal dealings, and therefore *guanxi* connections are deemed as substitutes for formal institutional support.⁴⁷⁷ This may explain the Chinese situation to some extent. However, with the development of the Chinese capital market, *guanxi* networks are thought to be less significant and durable than before.⁴⁷⁸ Since it is prominently rooted in Chinese culture,⁴⁷⁹ such interpersonal relationships are expected to prevail in business in China even once the legal framework is well established and operational.

In conclusion, unlike the German market where interpersonal relationships are considered supplementary to the firms' shareholding and institutional ways of coordination, *guanxi* networks are perceived as essential for firms' success in China. Establishing and maintaining sound personal relationships with key personnel in other firms also facilitates coordination at the institutional level, which, in turn, strengthens

⁴⁷³ C.A. McNally, "China's Changing Guanxi Capitalism: Private Entrepreneurs between Leninist Control and Relentless Accumulation" (2011) 13 *Business and Politics* 1.

⁴⁷⁴ D.Y. Lee and P.L. Dawes, "Guanxi, Trust, and Long-Term Orientation in Chinese Business Markets" (2005) 13 *Journal of International Marketing* 28.

⁴⁷⁵ C. Guo and J. Miller, "Guanxi Dynamics and Entrepreneurial Firm Creation and Development in China" (2010) 6 *Management and Organization Review* 267.

⁴⁷⁶ D.L. Wank, "The Institutional Process of Market Clientelism: Guanxi and Private Business in a South China City" (1996) 147 *The China Quarterly* 820.

⁴⁷⁷ K.R. Xin, and J.L. Pearce, "Guanxi: Connections as Substitutes for Formal Institutional Support" (1996) 39 *Academy of Management Journal* 1641.

⁴⁷⁸ M.W. Peng and J.Q. Zhou, "How Network Strategies and Institutional Transitions Evolve in Asia" (2005) 22 *Asia Pacific Journal of Management* 321.

⁴⁷⁹ I.Y.M. Yeung and R.L. Tung, "Achieving Business Success in Confucian Societies: The Importance of Guanxi" (1996) 25 *Organizational Dynamics* 54.

the interpersonal connections. Although *guanxi* networks are deeply rooted in Chinese culture, it is generally agreed that the main reason for Chinese firms' high dependence on interpersonal relationships to improve their competencies is due to the underdeveloped legal and regulatory frameworks. Firms' excessive reliance on interpersonal relationships with implicit commitments instead of explicit contracts or institutional frameworks may diminish transparency, predictability, and accountability, which is against the demands of the market. Therefore, although *guanxi* is expected to retain its extensive impact on the Chinese market in the future, a more detailed and effective legal framework is required to develop the economy.

4.3.5 Conclusion

This section compared German and Chinese firms' methods of coordination with other firms. In general, these economies show a high degree of similarity due to their low reliance on market mechanisms and similar ways of coordination. First, the Chinese party-state plays a similar role to banks in Germany in terms of their extensive shareholding and impact on corporate management. In particular, the decisive say of the party-state and German banks over firms' financing in their respective countries, alleviates the pressure of securing short-term gains and allows the firms to focus more on long-term value. Additionally, instead of following the market mechanism, firms in both these countries coordinate with other firms through cross-shareholdings, institutional coordination, and interpersonal relationships. It should be noted that due to their differing historical and political contexts, Chinese firms' ways of coordination are slightly different from their German counterparts. First, due to the party-state's dominance in the economy and deep participation in corporate management, economic actors in China need to take political objectives into consideration. Second, with the prevalence of *guanxi* relationships in China, firms' ways of coordination are central to their competencies while their organisational coordination is comparatively ineffective.

Under these unique political and cultural contexts, Chinese firms have different ways of coordinating with workers. For instance, Chinese workers' participation in corporate governance is much less effective than their counterparts in Germany. This

can be evidenced by the fact that Chinese firms do not have the German co-determination mechanism which empowers employee representatives to directly supervise corporate management. The coexistence of the German coordinated corporate structure and Chinese ways of treating workers may lead to incoherence, thereby negatively affecting the firm innovation. Therefore, this thesis suggests that workers' participation in corporate management should be improved, especially in hostile takeover decision-making as the workers would be vulnerable to unjust treatment in such situations. This is discussed in the next section.

4.4 Grounds for Introducing the German Co-Determination Mechanism in Takeovers from the Perspective of China

The Chinese economy shows a high degree of similarity to its German counterpart in the method of coordination among different firms, albeit with certain variations due to their differing political contexts. However, the Chinese industrial relation landscape is unique compared to that in place in both CMEs and LMEs; the methods of coordination that contradict lead to institutional incoherence, negatively affecting incremental and radical innovations. Hence, adapting the German model of industrial relations to the Chinese context would be beneficial for Chinese economic development.

This section begins with an examination of the mixed features of CMEs and LMEs that can be found in Chinese firms. Then, it moves on to validate the negative impacts of institutional incoherence on economic performance by analysing supporting and opposing arguments. Finally, it explains how Chinese institutions, especially those for employment relations, negatively affected the Chinese firms' innovative and economic performance during the economic transition.

4.4.1 Mixed Features of CMEs and LMEs in the Coordination of Chinese Firms

The VoC argument suggests that a country's satisfactory levels of long-term economic performance depend on its institutional complementarities. As defined by Hall and Soskice, "two institutions can be said to be complementary if the presence (or efficiency) of one increases the returns from (or efficiency of) the other".⁴⁸⁰ In general, institutional complementarities are widely observed in either LMEs or CMEs, and national economies with mixed features are deemed to be incoherent.⁴⁸¹ This incoherence is observed in China.

As analysed above, Chinese firms are highly similar to their counterparts in Germany in terms of coordination among firms, albeit with certain differences. On the other hand, when it comes to firms' coordination with workers, the landscape within which Chinese firms operate is starkly different to their German counterparts and share some features with firms in LMEs. This sub-section compares the coordination methods of workers in China, Germany, and LMEs to clarify whether there is any lack of institutional coherence in China.

First, in Germany, workers have strong bargaining power against employers to set wages, work conditions, benefits, and other aspects of workers' compensations and rights. This can be attributed to the independent unions, workers' representation on supervision boards, and workers' representation at the establishment level.⁴⁸² To be specific, collective bargaining is primarily conducted at the industry level between strong trade unions and employers' organisations on a fair and equal basis. Workplace and board-level participation, which is influenced by trade unions, can safeguard workers' information and participation rights in issues that directly relate to their interests.⁴⁸³ Their strong bargaining power can also attribute to workers deeper participation in corporate governance and affairs that are relevant with the interests of labour. This is discussed in a separate chapter in detail.

⁴⁸⁰ Hall & Soskice, *Varieties of Capitalism* (n 17) 17.

⁴⁸¹ Hall & Gingerich (n 435).

⁴⁸² J. Addison, P. Teixeira, K. Evers, and L. Bellmann, "Collective Bargaining and Innovation in Germany: A Case of Cooperative Industrial Relations?" (2017) 56 *Industrial Relations: a Journal of Economy and Society* 73.

⁴⁸³ European Trade Union Institute for Research, "Workplace Representation" (2016), available at <https://www.worker-participation.eu/National-Industrial-Relations/Countries/Germany/Workplace-Representation#>.

Second, CMEs are known to place a strong focus on vocational training. These firms are willing to pool resources to help develop workers' firm-specific or industry-specific skills, in contrast to LMEs where companies play a weak role in occupational training, and workers are usually educated in general skills.⁴⁸⁴ This is mainly for two reasons. For one, the German economy does not rely heavily on the market relationship between employees and employers to regulate the relationship with the labour force. Accordingly, employers are more willing to allocate a large share of costs towards improving their employees' skills and less worried that workers might leave their jobs after completing their training, especially compared to those in LMEs with flexible and fluid labour markets.⁴⁸⁵ With low levels of labour turnover, the employers are willing to establish a solid cooperation system with their employees, which positively affects the latter's productivity.⁴⁸⁶ Second, the German model of industrial relations and vocational training has certain historical origins. For instance, the apprenticeship system used in German training institutions can be traced back to the guilds in the Middle Ages.⁴⁸⁷

In comparison, the Chinese economy shows a different organisational landscape for the relationship between the employees and employers. Although similar workers' representation mechanisms exist at both the board and establishment levels, they are criticised as having low efficiency. Hence, German-style collaboration between the employees and employers has not been established. Instead, industrial relations in China are dominated by the party-state, to which the employees as well as employers are subordinated. As analysed in an earlier chapter, workers in China cannot actively participate in collective bargaining, and worker representation and participation mechanisms cannot effectively express workers' voices. Accordingly, these systems are perceived as formalities, and whether they can work effectively depends on the willingness of the party-state.⁴⁸⁸ With respect to vocational training and education

⁴⁸⁴ G. Bosch and J. Charest, "Vocational Training and the Labour Market in Liberal and Coordinated Economies" (2008) 39 *Industrial Relations Journal* 428.

⁴⁸⁵ D. Acemoglu and J. Pischeke, "Why do Firms Train? Theories and Evidence" (1998) 113 *Quarterly Journal of Economics* 79.

⁴⁸⁶ O. Hübler and U. Jirjahn, "Works Councils and Collective Bargaining in Germany: The Impact on Productivity and Wages" (2003) 50 *Scottish Journal of Political Economy* 471.

⁴⁸⁷ J. Mahoney and K. Thelen, "A Theory of Gradual Institutional Change" In J. Mahoney and K. Thelen (eds), *Explaining Institutional Change: Ambiguity, Agenda, and Power* (Cambridge University Press-2010) 1.

⁴⁸⁸ C.K. Chan and E.S. Hui, "The Development of Collective Bargaining in China: From 'Collective Bargaining by Riot'

(VET), the Chinese system is underdeveloped. Compared to the German system, VET in China has three characteristics. First, unlike the German dual system in which educational institutions and firms both play an active role in VET,⁴⁸⁹ the Chinese mechanism primarily relies on the former.⁴⁹⁰ Second, instead of industry-specific or firm-specific skills, the Chinese VET mechanism places emphasis on improving workers' general skills, which is similar to that of LMEs. This is evidenced by the fact that students who go to vocational schools are normally perceived as bad compared to their peers who go to schools for general education.⁴⁹¹ Third, the general skills that workers acquire through the Chinese VET mechanism do not align with the firms' needs. Therefore, there is a surplus of Chinese workers, and they are criticised as delivering low-quality work.⁴⁹²

Employer–employee cooperation is much weaker in China than in Germany, which is evidenced by low employee empowerment and the firms' passive role in VET. In this regard, the firms' relationship with their employees seems to be inclined towards LMEs rather than CMEs. This is evidenced by statistics showing that the employee turnover rate has remained at approximately 20% in recent years.⁴⁹³ However, unlike workers in LMEs, who rely heavily on the market mechanism, the labour market in China is much less fluid and flexible. This is partly due to the *hukou* system, which is said to “differentiate residential groups as a means to control population movement and mobility and to shape state developmental priorities”.⁴⁹⁴ The *hukou* system is deemed to restrict transregional labour movement, since workers who do not have a residential status cannot enjoy residential welfare such as local healthcare, housing

to ‘Party State-led Wage Bargaining’” (2013) 217 *The China Quarterly* 221.

⁴⁸⁹ H. Blossfeld, “Is the German Dual System a Model for a Modern Vocational Training System?” (1992) 33 *International Journal of Comparative Sociology* 168.

⁴⁹⁰ V. Stewart, “Made in China: Challenge and Innovation in China’s Vocational Education and Training System: International Comparative Study of Leading Vocational Education Systems” (2015) *National Center on Education and the Economy*, available at <http://ncee.org/wp-content/uploads/2015/03/CHINAVETFINAL1.pdf>.

⁴⁹¹ M. Ling, “Bad Students Go to Vocational Schools: Education, Social Reproduction and Migrant Youth in Urban China” (2015). 73 *The China Journal* 108.

⁴⁹² F. Cooke, “Vocational and Enterprise Training in China: Policy, Practice and Prospect” (2005) 10 *Journal of Asia Pacific Economy* 26.

⁴⁹³ The employee turnover rates are 20.2% in 2016 and 19.7% in 2017 respectively. See Aon Hewitt Human Capital Intelligence Study, available at <https://www.aonhewitt.com.cn>.

⁴⁹⁴ T. Cheng and M. Selden, “The Origins and Social Consequences of China’s Hukou System” (1994) 139 *The China Quarterly* 644.

assistance, and education assistance.⁴⁹⁵ In addition, a prerequisite for the economy's reliance on the market is the rule of law, which facilitates good faith, market stability, fairness, predictability, and confidence.⁴⁹⁶ The Chinese labour market is criticised for its ineffective legal system although there is a seemingly strong mechanism for employer–employee collaboration. This is discussed in detail in a separate chapter, but this situation reduces both the firms' and workers' reliance on the Chinese labour market. Therefore, an employee turnover rate that is similar to countries in LMEs is not caused by a developed market mechanism. Instead, interviews attribute this high rate to a lack of training schemes, unsatisfactory work environments, insufficient consideration for the employees' welfare, and so on.⁴⁹⁷ These problems can all be addressed by enabling workers' participation in corporate management, which is discussed later on in this section.

In conclusion, although the Chinese economy shows a high degree of similarity to German CMEs, the firms' relations with workers exhibit some characteristics that can be found in LMEs. However, due to their unique Chinese context, these firms struggle to rely on labour markets to coordinate with workers. This leads to a certain degree of institutional incoherence that may negatively impact the Chinese economy.

4.4.2 The Impact of Institutional Incoherence on the Economy

As suggested by the VoC argument, a country's satisfactory level of long-term economic performance depends on its institutional complementarities. For example, the CME economy being dominated by a few parties makes it less dependent on the market mechanism. Accordingly, a firm's low sensitivity to market profitability may reinforce long-term employment. This is normally accompanied by strong

⁴⁹⁵ J. Whalley and S. Zhang, "A Numerical Simulation of Analysis of (Hukou) Labour Mobility Restrictions in China" in J. Whalley (ed), *China's Integration into the World Economy* (World Scientific Publishing-2011) 295.

⁴⁹⁶ C. May, "Market Exchange and the Rule of Law: Confidence in Predictability" 10 *Hague Journal on the Rule of Law* 365.

⁴⁹⁷ See an interview of W. Wu conducted by Clark Morgan in 2014, available at <https://clarkmorgan.com/2014/06/20/for-the-90s-generation-money-isnt-everything-william-wu/>.

Also see Z. Zhang, "Making Sense of China: An Expert in Chinese Management Explains Why the Country isn't as Foreign as It Seems to Western Businesspeople" (2008) *Business Journal July 10th*, available at <https://news.gallup.com/businessjournal/108664/making-sense-china.aspx>.

employment protection and participation in corporate governance due to the demand for increased productivity. Therefore, when institutions are incoherent, they cannot effectively cooperate in national economies, and this may negatively affect overall economic performance.

However, it should be noted that whether institutional incoherence negatively impacts upon economic performance is debatable, and arguments exist for both sides. On the one hand, multiple empirical studies provide evidence highlighting the comparative advantage of institutional coherence in innovation and economic performance.⁴⁹⁸ Accordingly, national economies with a lack of institutional complementarities exhibit a comparative disadvantage in terms of both incremental and radical innovation.⁴⁹⁹ On the other hand, the opposing evidence posits that institutional incoherence does not necessarily lead to a negative impact on the level of a country's innovation.⁵⁰⁰ First, evidence shows that some national economies achieve sound innovative performance but conform to neither the CME nor the LME structures.⁵⁰¹ This opposes the argument that institutions in such national economies are incoherent. This counterargument is tenable since the institutional structures of either economy cannot be completely applied to all the countries of the world, even though CMEs and LMEs provide seemingly ideal market economy models, due to the differences in the countries' historical and cultural backgrounds. Therefore, national economies with mixed features of CMEs and LMEs can also be advantageous for incremental and radical innovation if they are compatible with the country's background. Second, these advantages may vary depending on factors other than institutional coherence, such as regional and sectoral differences.⁵⁰² This argument holds true since, even with the same institutional structures, firms across different regions or industries may have

⁴⁹⁸ M.R. Schneider and M. Paunescu, "Changing Varieties of Capitalism and Revealed Comparative Advantages from 1990 to 2005: A Test of the Hall and Soskice Claims" (2012) 10 *Socio-Economic Review* 731; M.C. Allen, "Comparative Capitalism and the Institutional Embeddedness of Innovative Capabilities" (2013) 11 *Socio-Economic Review* 771.

⁴⁹⁹ M.A. Witt and G. Jackson, "Varieties of Capitalism and Institutional Comparative Advantage: A Test and Reinterpretation" (2016). 47 *Journal of International Business Studies* 778.

⁵⁰⁰ T.H. Malik, "Varieties of Capitalism, Innovation Performance and the Transformation of Science into Exported Products: A Panel Analysis" (2017) 118 *Technological Forecasting & Social Change* 1.

⁵⁰¹ J.L. Campbell and O.K. Pedersen, "The Varieties of Capitalism and Hybrid Success: Denmark in the Global Economy" (2007) 40 *Comparative Political Studies* 307.

⁵⁰² C. Crouch, M. Schroder and H. Voelzkow, "Regional and Sectoral Varieties of Capitalism" (2009) 38 *Economy and Society* 654.

different innovation demands and capabilities. However, this does not counter the relevance of institutional complementarities in innovation and national economies. It points out that to achieve high levels of innovation performance, institutional structures should not be strictly adopted but remain flexible for firms to modify according to their regions and industries. Third, internationalisation exerts external pressure on national economies to partially change institutions and forces firms to make certain adaptations that fail to conform to the ideal LME and CME types.⁵⁰³ Again, this argument does not counter the relevance of institutional coherence in national economies, but it emphasises the dynamic nature of the VoC approach;⁵⁰⁴ i.e. the ideal model of institutional structures in national economies may change based on external pressures such as globalisation. Therefore, although some institutions are embedded in specific historical and political contexts, they cannot remain static and must be reformed if external and internal factors make current institutions incompatible with the need for economic development.

In summary, CME and LME models provide a benchmark for the Chinese economy. However, whether economic institutions are incoherent depends on their historic and political contexts, which vary across industries, and their dynamic or static natures. Thus, if institutional structures have the mixed features of LMEs and CMEs, this does not naturally lead to a lack of complementarities. Whether the current Chinese institutional framework negatively affects the Chinese economy is discussed further in the following section.

4.4.3 Institutional Incoherence of the Coordination of Chinese Firms

The forms of coordination of Chinese firms are embedded in certain historical and cultural backgrounds. However, while these methods were feasible in the past, they

⁵⁰³ M.C. Allen and R. Whitley, "Internationalization and Sectoral Diversity: The Roles of Organizational Capabilities and Dominant Institutions in Structuring Firms' Response to Semiglobalization" in C. Lane and G.T. Wood (eds), *Capitalist Diversity and Diversity within Capitalism* (Routledge-2012) 97.

⁵⁰⁴ R. Deeg and G. Jackson, "The State of the Art: Towards a More Dynamic Theory of Capitalist Variety" (2007) 5 *Socio-Economic Review* 149.

are incompatible in current circumstances and hinder the Chinese economy's need for incremental innovation.

Compatibility with Chinese Labour-intensive Economy

China was renowned for its labour-intensive industries, including manufacturing and construction industries. The economy did not have a high skilled labour demand before the economic transition starting from 2012,⁵⁰⁵ when labour intensive industries were dominant in the Chinese economy. Therefore, a well-developed VET mechanism was not necessary. In addition, a wide range of products made in China had a price advantage over overseas competitors. Low labour costs were one of the main contributors to the "China prices",⁵⁰⁶ and firms preferred to not invest in work training schemes to maintain the competitiveness of their products. Another consequence of this demand for competitive pricing was low employee empowerment. This was because stronger labour rights tended to make the management consider the workers' interests more, leading to increased labour costs and lowered profits. Another factor that contributed to the low levels of worker empowerment was the high surplus of unskilled labour. These workers were mainly from the rural sector and worked in the manufacturing and construction industries in the urban sector.⁵⁰⁷ Due to the residential restrictions arising from the *hukou* system, as mentioned earlier, their residential statuses in the cities were temporary. Therefore, these rural workers could not form stable and long-term employment relationships with the firms. While some of them voluntarily chose to leave their jobs, on the other hand, the employers could dismiss such low-skilled workers with low costs. This is because the labour laws in China lacked an effective enforcement mechanism.⁵⁰⁸ In addition, these low-skilled workers were vulnerable to unjust treatment since most of them were uneducated and lacked sufficient money to hire legal counsel.⁵⁰⁹ Since the cost of firing employees was low

⁵⁰⁵ P. Fajnzylber and A. Fernandes, "International Economic Activities and Skilled Labour Demand: Evidence from Brazil and China" (2009) 41 *Applied Economics* 563.

⁵⁰⁶ P. Navarro, "The Economics of the 'China Price'" (2006) 68 *China Perspectives* 1.

⁵⁰⁷ X. Wang and N. Weaver, "Surplus Labour and Lewis Turning Points in China" (2013) 11 *Journal of Chinese Economic and Business Studies* 1.

⁵⁰⁸ Y. Zheng, "It's Not What is on Paper, But What Is in Practice: China's New Labor Contract Law" (2009) 8 *Washington University Global Studies Law Review* 595.

⁵⁰⁹ D.K.F. Wong, C.Y. Li, and H.X. Song, "Rural Migrant Workers in Urban China: Living a Marginalised Life" (2007) 16 *International Journal of Social Welfare* 32.

and the firms could easily find alternatives due to the high surplus of unskilled labour, the turnover rates were high in China. Accordingly, the firms did not find it necessary to maintain their workers' loyalty or feel motivated to collaborate effectively with them.

In conclusion, the Chinese institutional structure is compatible with the economic context before the economic transition. In the present scenario, Chinese firms cannot rely on the market mechanism due to the party-state's dominance over the economy. Therefore, the firms' methods of coordination with other firms display the characteristics of CMEs. Further, Chinese firms do not have *de facto* strong collaboration with their workers, resulting in high turnover rates similar to LMEs. This arises from China's labour-intensive economy, which features a high labour surplus and low labour costs. However, it lacks the effective market mechanism that is widely found in LMEs, which distinguishes it from the latter.

Incompatibility during the Economic Transition

The current round of economic transition started in 2012,⁵¹⁰ when the party-state attempted to transition from a labour-intensive economy with a low-skilled labour demand to an economy emphasising innovation and requiring high-skilled employees.⁵¹¹ As a result, the Chinese economic transition resulted in weak employer–employee collaborations incompatible with their developmental goals.

The increased needs for innovation can be exemplified by the rapid growth of Chinese firms' expenditures on R&D from RMB 36.25 billion in 2005 to RMB 120.13 billion in 2017.⁵¹² Innovation in the Chinese economy is cultivated based on two aspects. First, the high-tech industry is deemed to be the strategically leading industry in the national

⁵¹⁰ The Communist Party of China, *The Resolution of 18th National Congress of the Communist Party of China* (中国共产党第18次全国代表大会决议) (2012).

⁵¹¹ The State Council of PRC, *Outline of National Innovation-Driven Development Strategy* (国家创新驱动发展战略纲要) (2016).

⁵¹² China Science and Technology Statistics, available at [http://www.sts.org.cn/Page/Content/Content?ktype=4&ksubtype=1&pid=24&tid=88&kid=2074&pagetype=1&is_top=\[IsShow\]](http://www.sts.org.cn/Page/Content/Content?ktype=4&ksubtype=1&pid=24&tid=88&kid=2074&pagetype=1&is_top=[IsShow]).

economy by the party-state. China “plays a significant role in the international high-tech production chain”.⁵¹³ Second, stronger innovative capabilities are needed to enhance the efficiency of even the manufacturing industry, which is characterised by low-skilled labour, by improving the production process, reducing the consumption of energy and raw materials, and improving product quality.⁵¹⁴

Under the context of the VoC, there are two types of innovation: radical and incremental. This thesis maintains that innovation in China shows more characteristics of incremental innovation and, accordingly, considers the CME model as one that is suitable to be introduced as compared to the LME model. As defined by Hall and Soskice, the former “entails substantial shifts in product lines, the development of entirely new goods, or major changes to the production process” and the latter is “marked by continuous but small scale improvements to existing product lines and production processes”.⁵¹⁵ Hence, the manufacturing industry seems to require a capacity for incremental innovation while radical innovation is especially important in high-tech industries. Due to the distinct institutional features of CMEs and LMEs, incremental innovation gains more support in CMEs while radical innovation gains high support in LMEs. Therefore, the adoption of the CME mechanism is conducive to the development of the manufacturing industry. Considering the significant role of the high-tech industry in the Chinese economic transition, as mentioned above, the LME institutional framework seems more likely to be adopted. However, and especially considering the major path to innovation taken by Chinese firms, this is not actually the case. Unlike companies in LMEs that are highly innovative right from the start, most Chinese companies start off as imitators.⁵¹⁶ Driven by the rapidly changing demands of customers and a highly competitive market, these firms are forced to innovate at an incremental rate to survive.⁵¹⁷ Although Chinese firms’ are criticised as

⁵¹³ Z. Zhao and C. Yang, “An Empirical Study of China’s High-Tech Industry Innovation Capability in Transition” in H. McKay and L. Song (eds), *Rebalancing and Sustaining Growth in China* (Australian National University Press-2012). 289.

⁵¹⁴ J. Guan, R.C. Yam, E. Tang, and A. Lau, “Innovation Strategy and Performance during Economic Transition: Evidences in Beijing” (2009) 38 *Research Policy* 802.

⁵¹⁵ Hall & Soskice, *Varieties of Capitalism* (n 17) 38.

⁵¹⁶ M.W. Peng, D. Ahlstrom, S.M. Carraher and W. Shi, “History and the Debate over Intellectual Property” (2017) 13 *Management and Organization Review* 15.

⁵¹⁷ D. Breznitz and M. Murphree, “China’s Run- Economic Growth, Policy, Interdependences, and Implications for Diverse Innovation Policies in a World of Fragmented Production” in D. Breznitz and J. Zysman (eds), *The Third*

lacking innovative capability, they have quick responses to a variety of consumers' needs. This is particularly the case considering that Chinese people have increased demands for consumption.⁵¹⁸ This can be exemplified by the rising trend of consumption expenditure from RMB 13,471 in 2010 to RMB 19,852 in 2018.⁵¹⁹ Accordingly, Chinese firms endeavour to provide sophisticated products tailored to their consumers' rapidly changing needs. With the high competition in the market, firms have to upgrade their products to survive.⁵²⁰ The incremental innovation is evidenced by an interview conducted by M. J. Greeven and G. S. Yip between 2011 and 2017, in which executives of Western firms were concerned about Chinese products that offer "twice the number of features as Western products at half price".⁵²¹ For example, Didi Chuxing, a Chinese ride-hailing firm, has much richer and user-friendly functions for Chinese customers than its competitor Uber, one of the first ride-hailing firms in the Western world. Due to this, Uber agreed to transfer its Chinese operations to Didi in 2016.⁵²² On the other hand, some Chinese firms are characterised as offering new-to-world technologies, such as Huawei, Tencent, or Alibaba. However, their radical innovations are developed by the firms' consistent incremental product upgrading, which, in turn, improves their innovative capability.⁵²³

In conclusion, the innovation mechanism in Chinese firms is more incremental than radical. Even in the high-tech industries, such as telecommunication, information technology, and computing, some firms are steadily progressing from incremental innovation to radical innovation. Considering that China is moving towards a more innovative economy, the CME institutional framework is feasible. In addition to the

Globalization: Can Wealthy Nations Stay Rich in the Twenty-First Century (Oxford University Press-2013) 36.

⁵¹⁸ G. Yip and B. Mckern, "Innovation in Emerging Markets- the Case of China" (2014) 9 *International Journal of Emerging Markets* 2.

⁵¹⁹ National Bureau of Statistics, "Statistics on Residence Income and Consumption Expenditures of 2018 (2018 年居民收入和消费支出情况)" (2019), available at http://www.stats.gov.cn/tjsj/zxfb/201901/t20190121_1645791.html.

⁵²⁰ P.J. Williamson and E. Yin, "Accelerated Innovation: The new Challenge from China" (2014) 55 *MIT Sloan Management Review* 27.

⁵²¹ M.J. Greeven and G.S. Yip, "Six Paths to Chinese Company Innovation" (2019) *Asia Pacific Journal of Management* available at <https://doi.org/10.1007/s10490-018-9635-3>.

⁵²² The Economist, "Ride-hailing in China: Uber Gives App" (2016), available at <https://www.economist.com/business/2016/08/06/uber-gives-app>.

⁵²³ G.S. Yip and B. Mckern, *China's Next Strategic Advantage: From Imitation to Innovation* (MIT Press-2016) 75.

demands for innovation, the new economic context requires solid cooperation between employers and employees, making the CME framework even more practical.

With the development of an innovative economy, Chinese firms have an increasing need for high-skilled workers. This can be evidenced by the fact that R&D personnel rose from 0.173 million in 2005 to 4.045 million in 2017.⁵²⁴ However, Chinese firms are known to have a shortage of technicians, entrepreneurs, engineers, and other professionals.⁵²⁵ Therefore, they have a pressing need to retain the loyalty of high-skilled employees by establishing a strong employer–employee collaboration system, especially considering the weakness of the Chinese labour market. Meanwhile, the Chinese market has been dealing with labour shortages in labour-intensive industries. Since the economic reform that started in the 1980s, China has seen a sharp drop in fertility, leading to an ageing population. A higher proportion of older people in China has resulted in a downward trend in the number of working-age workers since 2011, when the Chinese workforce reached its peak at 941 million.⁵²⁶ By 2018, working-age workers declined to 897 million, and this number has been projected to further reduce by 70 million in 2030. This leads to labour shortages, especially in labour-intensive industries where workers are generally uneducated.⁵²⁷ This can explain factories' battle for migrant workers due to labour shortages.⁵²⁸

On the other hand, with China's economic development, workers have increased demands for job security and greater participation in corporate decision-making, especially for affairs that directly relate to the interests of workers. This indicates that a more innovative economy encourages workers to improve their firm-specific or industry-specific skills by investing more time and efforts in their companies. As a

⁵²⁴ China Science and Technology Statistics (n 512).

⁵²⁵ L. Chen, H. Chan, J. Gao, and J. Yu, "Party Management of Talent: Building a Party-led, Merit-based Talent Market in China" (2015) 74 *Australian Journal of Public Administration* 298.

Also see National Bureau of Statistics of China, *China Statistical Yearbook* (China Statistics Press-2018), available at <http://www.stats.gov.cn/tjsj/ndsj/2018/indexeh.htm>.

⁵²⁶ National Bureau of Statistics of China, *BRICS Joint Statistics Publication 2017* (2017), available at http://www.stats.gov.cn/ztc/ztsj/jzqjlhtjzc/jz2017/201709/t20170901_1530134.html.

⁵²⁷ Z. Zhang, "Shortage of Migrant Workers: The Present and the Future" (2008) 3 *Population and Development* 19.

⁵²⁸ China Daily, "Labour Shortage Hit China" (2011), available at http://www.chinadaily.com.cn/china/2011-02/21/content_12052550.htm.

result, workers tend to establish long-term relationships with their employers. This is because, upon leaving their jobs, workers would be unable to easily find new jobs due to the underdevelopment of the labour market, and their acquired skills may not be transferrable to other work positions.

The party-state formulated a series of labour laws, particularly labour contract laws, to improve workers' protection and promote their participation in corporate management, with the objective of improving employee–employer collaborations. However, these laws are far from satisfactory, especially for labour-intensive workers who remain the dominant group in China.⁵²⁹ With the economic transition, the employer–employee bond has become even weaker than before. This started during the industrial restructuring that took place under the economic reform of the state sector. A large number of workers lost their jobs involuntarily in lay-off waves.⁵³⁰ According to the statistics published by the Xinhua Press, in the last round of SOE reform, 21.37 million workers were dismissed between 1998 and 2000.⁵³¹ A large number of these laid-off workers were forced to leave without satisfactory resettlement and compensation, leading to severe social stability problems.⁵³² In this round of reform starting from 2017,⁵³³ laid-off, as a key word, was raised again by the state-party, and approximately six million SOE workers are projected to leave their positions within the next three years.⁵³⁴ The staggering loss of lifelong employment increases the need for workers to safeguard their legal rights.⁵³⁵ This is observed via the occurrence of intense labour conflicts. Chinese scholars have found evidence of a sharp increase in labour disputes, reflecting the “deep contradictions among labour, capital, and the Chinese state”.⁵³⁶

⁵²⁹ The Economist, “Workers Disunited: China’s Labour Law is No Use to Those Who Need It Most: But Very Helpful to Crooked White-Collar Workers” (2017), available at <https://www.economist.com/china/2017/08/17/chinas-labour-law-is-no-use-to-those-who-need-it-most>.

⁵³⁰ H.Y. Lee, “Xiangang, the Chinese Style of Laying Off Workers” (2000) 40(6) *Asian Survey* 914.

⁵³¹ Xinhua news, available at http://news.xinhuanet.com/employment/2003-01/24/content_702257.htm.

⁵³² According to a survey conducted by S. Wang, the lay-offs are one of the main reasons causing the social instability in the end of 1990s and early 2000s. S. Wang, A. Hu, and Y. Ding, “Social Instability behind the Economic Prosperity” (经济繁荣背后的社会不稳定) (2002) 3 *Strategy and Management* (战略与管理) 26.

⁵³³ In this year, the 19th National Congress of Communist Party of China was held.

⁵³⁴ B.K. Lim, M. Miller, and D. Stanway, “Exclusive: China to Lay Off Five to Six Million Workers, Earmarks at Least \$23 Billion” (2016) *Reuter News*, available at <http://uk.reuters.com/article/us-china-economy-layoffs-exclusive-idUKKCNOW33DS>.

⁵³⁵ E.P.W. Huang and S.W.K. Chiu, “The Lost Generation: Life Course Dynamics and Xiangang in China” (2003) 29 *Modern China* 204.

⁵³⁶ J. Chan and M. Selden, “China’s Rural Migrant Workers, the State, and Labor Politics” (2014) 46 *Critical Asian Studies* 599.

There are frequent outbreaks of labour unrest, with workers expressing their need for better protection of their legal rights and deeper participation in corporate management. According to the China Labour Bulletin, a Hong Kong-based watchdog, there were 1705 and 1052 labour strikes in China in 2018 and 2019 (by October), respectively. The researchers have suggested that this may only represent 10–15% of the actual number of cases.⁵³⁷ This substantiates the need for a stronger labour protection and participation mechanism in China.

In conclusion, weak collaboration between firms and workers is no longer compatible with economic development in China, and a mechanism that strengthens workers' protection and participation in corporate management is necessary. The German co-determination system may be a model worth considering in greater detail and ultimately introducing.

4.4.4 Conclusion

This section aims to lay the foundations for the introduction of the German method of coordination with workers into the Chinese economy. Due to the dominance of the party-state over the Chinese economy, Chinese firms can no longer rely on the market mechanism for coordinating with other firms and share some characteristics with the German CME model. However, unlike the latter, the management of Chinese firms does not establish close relationships with their workers, a characteristic that emerged from the labour-intensive economy.

Innovation has been highlighted in this round of economic reform, making it necessary for firms to retain their high-skilled workers. In addition, due to the decline in the working-age population and weakness of workers' protection, firms and low-skilled workers now demand better methods of cooperation. As a result, the Chinese economy lacks institutional complementarities, which may hinder economic development. Therefore, it may be advisable to introduce a Chinese co-determination mechanism to achieve institutional coherence. This does not mean that the German style of worker

⁵³⁷ China Labor Bulletin, "Strike Map" (2019), available at <https://maps.clb.org.hk/strikes/en>.

treatment is the only effective way to address Chinese problems. However, due to the similarities between Chinese and German firms, it is one of the most direct and effective ways to adapt such a mechanism into the Chinese economy.

4.5 Concluding Remarks

This chapter provided the basis for the introduction of the German co-determination mechanism in the context of Chinese takeovers by using the VoC approach. CMEs and LMEs, the models provided by the VoC approach, is at opposite poles of the spectrum. The former is represented by Germany and the latter by the US and the UK. In general, firms' core relationships are of two types: those with other institutions and those with their own employees. With the dominance of the Chinese party-state over the economy, firms are now less dependent on the market mechanism, and accordingly their methods of coordination with other institutions are highly similar to those of the German CME model. However, Chinese employers do not establish strong collaborations with their employees, unlike their German counterparts, which is similar to the system in LMEs. These mixed features are caused by the labour-intensive nature of the Chinese economy, which is currently undergoing a transition to a more innovative economy. Considering this shift, it is necessary to establish stronger cooperation between employers and employees, especially to improve workers' empowerment. The German co-determination mechanism seems to be a model worth introducing, especially considering the high degree of similarities between the German and Chinese economies.

Adapting the German co-determination mechanism to the Chinese economy as a whole is too ambitious for this thesis. For a more focused and realistic objective, the thesis attempts to limit the emphasis to an analysis of the passivity of introducing this system in the context of hostile takeovers, during which workers are particularly vulnerable to unjust treatments by their employers. This could be the starting point of an institutional reform which may snowball into changes in other spheres as well, such as the entire corporate governance system. After endeavouring the introduction of a co-

determination system and its coherence with the Chinese economic system, this thesis moves on to compare the system with Chinese schemes and to identify its advantages.

Chapter 5: The German Co-Determination Mechanism

Unlike China, where workers lack effective ways to express their voice during the takeover process, Germany is renowned for its strong labour protection laws and the employees' high degree of participation in the decision-making process. This mainly arises from Germany's co-determination system. Since legal transplantation is one of the most widely accepted ways for legal development,⁵³⁸ analysing the German system for solutions to the problems in China would be beneficial.

To achieve this objective, it is necessary to examine the differences between the German and Chinese mechanisms, understand the factors that make labour protection much stronger in the former, and then explore how the German system can be adapted to the Chinese corporate framework.

This chapter focuses on the first step, i.e. comparing the German co-determination mechanism with its Chinese counterpart. Accordingly, it begins with a summary of the co-determination system, moves on to compare the mechanisms in detail, and finally, provides a conclusion about the major obstacles faced by China to effectively protect employees' interests.

5.1 A Summary of the Co-Determination System in Germany

The co-determination system guarantees the presence of a strong voice for workers in both “the terms and conditions of the employment and the economic planning” and the “decision-making of the company”.⁵³⁹ This high level of workers' involvement is achieved through two channels: the workers' representation on the board and the works council. In the context of takeovers, the former ensures that labour interests are considered during the decision-making process, albeit in the best interests of the shareholders and company, while the latter helps safeguard the employees' interests

⁵³⁸ A. Watson, *Legal Origins and Legal Change* (Hambleton Press-1991) 73.

⁵³⁹ Federal Ministry of Labour and Social Affairs of Germany, *Co-determination 2018* (2018). 4.

and address their immediate concerns, such as changes in wages and work conditions or lay-offs.

5.1.1 Co-determination at the Board Level

Corporate boards in Germany have a two-tier structure,⁵⁴⁰ each with a supervisory and management board. The corporate structure of German companies is illustrated in diagram 4. The members of the management board jointly manage the company,⁵⁴¹ while the supervisory board has the power to appoint and dismiss members and oversee the management of the management board. The articles of association and the supervisory board determine that certain transactions made by the management board should be upon the consent of the supervisory board *ex ante*.⁵⁴² The members of the supervisory board are generally elected and appointed by the shareholders and employees, respectively; the number of employee-elected representatives increases with burgeoning workforce size. The employee members, including the employee and trade union representatives, constitute a third of the supervisory board in companies with 501–2000 employees⁵⁴³ and half of the board in companies with over 2000 employees.⁵⁴⁴ If the shareholders and employee members cannot reach an agreement in the larger companies, the chairman of the board has a casting vote.⁵⁴⁵ It should be noted that in companies that may affect the public interest, representatives of the state may also be appointed to the supervisory board.

⁵⁴⁰ As a prominent feature, this two-tier structure is not mandatorily applied to all the firms in Germany. For example, the European companies may choose its board structure between one-tier and two-tier. See 1 Forward, *German Corporate Governance Code* (2017).

⁵⁴¹ § 77 of the *Stock Corporation Act* (2016).

⁵⁴² § 111 of the *Stock Corporation Act* (2016).

⁵⁴³ Section 4, the *Law on One-Third Employee Representation in the Supervisory Board* (2015).

⁵⁴⁴ Section 7, the *Co-determination Act* (2015).

⁵⁴⁵ Section 29, the *Co-determination Act* (2015).

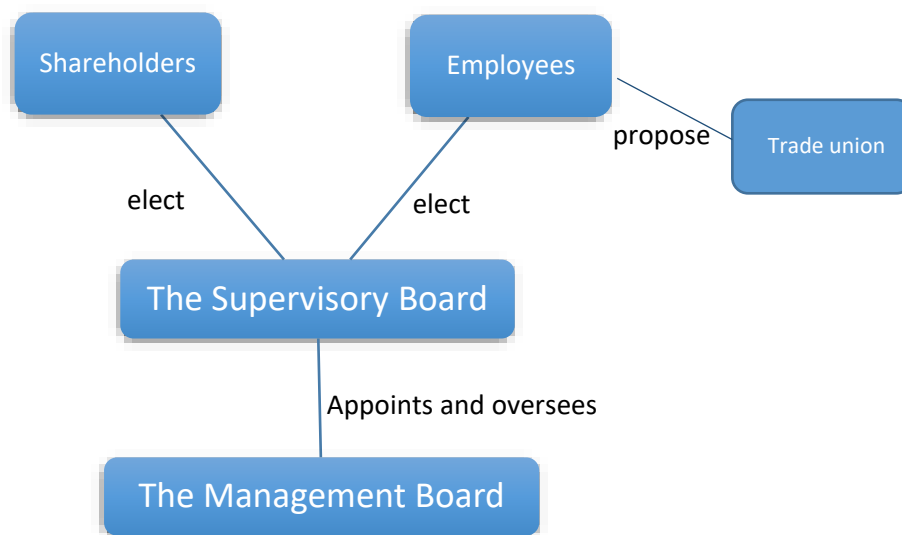


Diagram 4: the structure of the German co-determination mechanism

With this two-tier structure, the employees are able to exert a substantial amount of influence over the management as well as corporate governance through the members on the supervisory board. During takeovers, the employees' participation and information rights are also protected by the representatives on the supervisory board; the supervisory board is directly involved in the decision-making process for takeovers.⁵⁴⁶ Although the shareholders have decisive power over the decision-making process, the supervisory board issues a statement with their reasoned opinions, including the effects of the takeover on the interests of the employees. This is an important basis for shareholders to make informed decisions⁵⁴⁷ and is considered an important factor for the success or failure of a takeover.⁵⁴⁸ Rarely, the management board is allowed to take frustrating actions, albeit with the consent of the supervisory board.⁵⁴⁹ As a result, a coalition of the two boards is formed to fight off hostile

⁵⁴⁶ Article 5.1.1 of the *German Corporate Governance Code* (2017).

⁵⁴⁷ Article 3.7 of the *German Corporate Governance Code* (2017).

⁵⁴⁸ K.J. Hopt, "Takeover Defenses in Europe: A comparative, Theoretical and Policy Analysis" (2014) 20 *Columbia Journal of European Law* 249 at 272.

⁵⁴⁹ Section 33a of the *Securities Acquisition and Takeover Act* (2011).

takeovers.⁵⁵⁰ The members representing the employees are kept informed by the management board throughout the takeover process.⁵⁵¹

To summarise, workers' claims are taken into account in takeover scenarios due to the presence of their representatives on the supervisory board. However, these members' promotion of employees' interests may be compromised because they are also legally bound to work towards the best interests of the company and its shareholders.⁵⁵² The supervisory board works at the corporate governance level and does not handle the employees' daily concerns such as wages or work conditions. These issues are generally addressed by the works council, which is introduced in the next section.

5.1.2 The Works Council

The works council is an establishment-level workers' representation organisation. It works in cooperation with the employer to safeguard the interests of the employees in any workplace. The works council has the right of co-determination, especially for arrangements, such as working hours, employee conduct, and holiday policies, that directly relate to the workers' interests.⁵⁵³ The work council is involved in matters of personnel arrangements; it must approve the hiring and transfer of employees and be consulted before any dismissals. The works council's objection over a dismissal provides additional support for the dismissed if he/she files an action in court. In matters related to the restructuring of the establishment, such as a transfer of important departments, an amalgamation with other establishments, or a split-up of establishments, the employer is expected to reach an agreement with the works council on the reconciliation of the interests before these operational changes are implemented.⁵⁵⁴

⁵⁵⁰ K.J. Hopt, "The German Law of and Experience with the Supervisory Board" (2016). *European Corporate Governance Institute (ECGI) - Law Working Paper No. 305/2016*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2722702.

⁵⁵¹ Article 3.4 and Article 5.2 of *German Corporate Governance Code* (2017).

⁵⁵² Article 3.7 of *the German Corporate Governance Code* (2017).

⁵⁵³ Section 87 of *the Works Constitution Act* (2017).

⁵⁵⁴ Section 99, Section 102, Section 103, Section 111, and Section 112 of *the Works Constitution Act* (2017).

The works council's right of co-determination provides employees with sound protection in their day-to-day work. While the transfer of shares during a takeover does not trigger the co-determination right of the works council, the acquirer has to be particularly cautious of any possible arrangements with the employees, such as mass lay-offs or job transfers, after the completion of the takeover, considering the works' council's wide range of co-determination rights, as mentioned earlier. In addition, the works council is also actively informed during the process of takeovers. In particular, in the case of companies with over 100 permanent employees, the finance committee⁵⁵⁵ that is affiliated to the works council must be informed, well beforehand, of the potential acquirer, their intentions for the company's future business activities, and the potential effects on the employees. Afterwards, the employees should be informed of the financial situations and takeover process on a regular basis.⁵⁵⁶

To summarise, before the completion of a takeover, the works council's role is to cooperate with the employer to safeguard the employees' information rights, and after the completion of a takeover, it endeavours to ensure that the workers are well and fairly treated by the new employer.

5.2 A Comparison of the Mechanisms in Germany and China

With the co-determination system in place, Germany has strong labour protection mechanisms during takeovers, which involve three aspects. First, the workers are able to participate in takeover decisions through their representatives on the supervisory board. Second, the employees' information rights are guaranteed by the supervisory board as well as the works council. Third, the works council's co-determination rights focus on ensuring the fair treatment of the employees after the takeover. While the Chinese approach shares some similarities with the German one, China's labour protection system is significantly weaker. To analyse the reasons for such different degrees of protection, this section compares the Chinese and German co-determination systems, beginning with the board regimes in each country.

⁵⁵⁵ If there is no finance committee, the works council should be involved in the takeover.

⁵⁵⁶ Section 106 and 109 of *the Works Constitution Act* (2017).

5.2.1 Employee Representation at the Board Level

Like the corporate structure of German corporations, Chinese companies have a two-tier board system consisting of the BoD and BoS. Like its German counterpart, the Chinese BoS also includes a number of employee representatives,⁵⁵⁷ who could work to safeguard labour interests during takeovers, as per the context of this thesis. However, they are unable to do so for two reasons.

First, the BoS, as the supervisory organ, has limited power in the process of takeovers compared to its counterpart in Germany. Unlike the latter, which has control over the management board, the BoS in China does not hold power over the BoD in the appointment or dismissal of members or fundamental decision making. Instead, the BoS oversees the management of the BoD on the behalf of the shareholders *ex post*.⁵⁵⁸ This generally involves consulting with the BoD on financial matters and getting involved if business mistakes by the BoD hurts the interests of the firm. As a result, the BoS has much weaker power than its counterpart in Germany. During takeover situations, the BoS plays a passive role. The role of the BoS is restricted to general care and diligence, without any operational right to actively participate in the takeover decision-making process. The shareholders have the power to make decisions during a takeover, similar to their counterparts in Germany; however, their decisions are based on the inputs of the BoD and not the BoS. An action taken by the BoD does not require approval from the BoS unless there is a violation of laws.⁵⁵⁹ Further, there is no legal requirement or procedure for the BoS to access information regarding the takeover bid in a timely manner. Unlike the German system, the BoD has no legal obligation to keep the BoS informed of any major decisions. While the members of the BoS have the right to attend the meetings of the BoD,⁵⁶⁰ providing them with the opportunity to be involved in a takeover scenario, the attendees can only question and provide recommendations for, rather than vote on, the board resolutions. Since it is considered

⁵⁵⁷ Pursuant to Article 51, 70 and 117 of the *Company Law of PRC*, the employee members on the BoS should not be less than 1/3.

⁵⁵⁸ Article 53 and 118 of the *Company Law of PRC*.

⁵⁵⁹ Article 8 of *Takeover Measures*.

⁵⁶⁰ Article 54 of the *Company Law of PRC*.

a right and not a duty, the liability of the BoD for a failure to informing the members of the BoS about its meetings are not specified in Chinese laws; the latter are also not liable if they are absent from BoD meetings.⁵⁶¹ As a result, BoS members rarely attend BoD meetings.⁵⁶²

Second, it is highly debatable whether the employee members on the BoS can represent the general employees, primarily because very few of them are shop-floor workers. It should be stressed that Chinese laws forbid directors and the senior management from being employee supervisors.⁵⁶³ However, the restriction leaves behind a fairly wide scope of candidates, including cadres of the CPC committee and executives of the firm. According to reported statistics, nearly half of the employee supervisors in Chinese companies belong to the former group,⁵⁶⁴ and they are usually (vice) chairmen of the trade union⁵⁶⁵ or party leaders who are responsible for disciplinary inspections. Due to the CPC committee's deep involvement in corporate governance and, accordingly, their strong connections with the BoD and senior management, these so-called employee representatives tend to be reluctant to speak on the behalf of the grassroots employees when their interests are at odds with the management. Further, a large number of the employee supervisors are executives, including senior management members of the subsidiaries, financial managers, and office administrators of the firm. Their remunerations and promotion prospects are decided by the BoD and senior management, whereas there are no criteria to assess the performance of the employee representatives on the BoS.⁵⁶⁶ Therefore, employee representatives tend to neglect their responsibilities rather than fight for labour interests against their superiors. In contrast, German laws have specific rules regarding the composition of the boards and guarantee that a part of the supervisory board would must consist of members elected

⁵⁶¹ Z. Zhang, "An Interpretation of Article 54 and 55 of the Company Law of China" (我国公司法第 54 条、第 55 条解读) (2009) 12 *Modern Finance & Economics* (现代财经) 87.

⁵⁶² Y. Wang and D. Zhao, "the Reform on the System of the Board of Supervisors of Chinese Listed Companies" (论中国上市公司监事会制度的改革) (2016) 1 *Social Science Research* (社会科学研究) 89.

⁵⁶³ Article 51 of the *Company Law of PRC* and Article 39 of *Democratic Management Provisions* (2012).

⁵⁶⁴ R. Yang, C. Liu, L. Dang, "Employee Supervisors, Economic Democracy, and Enterprise Income Distribution: Evidence from the Listed Central Enterprises of China" (职工监事、经济民主与企业内收入分配-- 央企上市公司的经验证据) (2017) 4 *Journal of Remin University of China* (中国人民大学学报) 48.

⁵⁶⁵ As mentioned above, the trade union is under the leadership of the party-committee of the company.

⁵⁶⁶ Y. Zhou, "Thoughts on the System of Employee Supervisors and Directors" (对职工董监事制度的思考) (2015) 4 *Labour Union Studies* (工会理论研究) 15.

by shop-floor employees.⁵⁶⁷ Members representing the employees' interests are expected to be company employees themselves or trade-union representatives. The former group is required to reserve one seat for the managerial staff. It is advantageous to have different groups representing labour interests as each of them can make up for the others' disadvantages. For instance, establishment-level members would have "valuable first-hand operational knowledge"⁵⁶⁸ and sufficient information about employees⁵⁶⁹ that the other groups would not. An executive employee with managerial capabilities and experience would be able to cope with making major decisions, as a member of the supervisory board, while the trade-union representatives would have sufficient knowledge and experience in safeguarding labour interests. Thus, labour interests are one of the primary concerns on the supervisory board in German companies, but the same is not observed in Chinese companies.

Despite the lack of a requirement for the composition of the BoS, the employee members could safeguard labour interests if the process of their election reflected the will of the general employees. Hence, the election process is another factor that leads to the supervisors' dilemma in representing the workers. Legislation requires the supervisors to be elected by employees.⁵⁷⁰ However, the election process heavily depends on the arbitrary decision of the party-state in action, during the nomination of the supervisor candidates. These candidates are required to be nominated by the trade union⁵⁷¹ and then approved by the firm's CPC committee.⁵⁷² Due to a lack of detailed rules on the composition of the employee members on the BoS, the party-committee and trade union exercise their discretion while selecting candidates, who may be for or against labour interests. Further, the nomination process is not a transparent one, and the employees cannot monitor it. Without the right to nominate or monitor, the election by workers or their representatives⁵⁷³ in the Workers' Congress becomes a rubber-stamp process that cannot reflect the workers' will, especially since the election is

⁵⁶⁷ Section 7 and 15 of *the Co-determination Act* (2015).

⁵⁶⁸ Fauver and Fuerst (n 250).

⁵⁶⁹ J.B. Berk, J.H. Van Binsbergen, and B. Liu, "Matching Capital and Labor" (2017) 72 *The Journal of Finance* 2467.

⁵⁷⁰ Article 36 of *Democratic Management Provisions* (2012).

⁵⁷¹ Article 51 of *the Company Law of PRC*.

⁵⁷² ACFTU, "Opinions of All-China Federation of Trade Unions on Further Promoting the System of Employee Directors and Supervisors" (中华全国总工会关于进一步推行职工董事、职工监事制度的意见) (2006).

⁵⁷³ Article 51 of *the Company Law of PRC*.

organised by the trade union. In Germany, the trade union, employees, and executive staff have the right to nominate their respective representatives in an election organised by the works council,⁵⁷⁴ a highly credible organ for safeguarding workers at the establishment level. Therefore, the grassroots workers' demands are expected to be fully respected. In addition, measures are taken to ensure that the election is not affected by other parties. For instance, voting must be conducted via a ballot, and the election process should not be obstructed.⁵⁷⁵ Thus, German companies have detailed rules to guarantee that the elections reflect the workers' will, whereas in China, the election process is left to the discretion of the trade union and the CPC committee of the firm. As a result, the election is at the risk of being manipulated.

Unlike the German system, Chinese employees also have representatives on the BoD, which could help them exert a substantial amount of influence on the takeover decision-making process. This could enable employees to obtain the right of co-determination in the takeover process at the board level, even though the power of the BoS is weak compared to the German supervisory board. However, due to the weakness of employee board representation, this objective cannot be achieved. This was analysed in detail in section 3.4.

In conclusion, the supervision organs in China and Germany both include a certain number of employee members, aiming to safeguard the interests of labour. However, due to the differences in the functions and procedures of the representative elections, the BoS in Chinese firms is much weaker in safeguarding the employees' interests. One of the most apparent reasons is the lack of detailed and transparent rules to guarantee the accountability of employee members on the BoS without them worrying about receiving negative treatments by their superiors. However, the deeper reason is that these institutions lack independence from the management. The extent to which employees' rights can be upheld is also affected by the party-state, which can exert substantial influence over corporate takeover decisions through regulatory and non-regulatory methods. As a result, takeover decisions made by the management of

⁵⁷⁴ Section 6 of the *Law on One-Third Employee Representation in the Supervisory Board* (2015).

⁵⁷⁵ Section 15, 16 and 20 of *Co-determination Act* (2015).

private firms may be based on the party-state's instructions, making it a challenge for workers to demand their participation rights when there's a conflict of interest with the party-state. While the party-state does have an interest in safeguarding labour interests, it is only one of their multiple considerations in addition to increasing tax revenues or making political advancements. Therefore, employees' rights cannot be effectively upheld since the management may prioritise the interests of other stakeholders, especially the shareholders and party-state.

As the above analysis indicates, employees in Chinese firms cannot effectively participate in the takeover decisions through their representatives on the boards. In addition to the board level, workers in Germany have the co-determination right at the establishment level. It is noted that there is a similar worker representation organ in Chinese firms: the Workers' Congress. Accordingly, in the next part, a detailed comparison of the Workers' Congress and the works council is provided to understand the reasons for the ineffectiveness of the Chinese mechanism.

5.2.2 Employee Representation at the Establishment Level

The Workers' Congress in China has long been blamed as formalistic and having no real effect on the safeguarding of labour interests. The primary reason was examined in Chapter Three, which is that the Workers' Congress was embedded in the old socialist planned economic system and does not fit into the current corporate structure. This part attempts to explore other reasons for its ineffectiveness by comparing the rules of the Workers' Congress to those of the works council in Germany.

We consider the works council as the counterpart of the Workers' Congress due to their high degree of functional similarities. Specifically, they are both obliged to be involved in the decision-making process when it directly concerns employees' interests, such as a change in remuneration or work hours. During takeovers, the management boards of firms in China and Germany are required to inform and consult the Workers' Congress and the works council, respectively, about the potential takeover and any possible consequences for the employees. This ensures that the new

employer takes the labour interests into consideration after the completion of the takeover. However, the Workers' Congress and works council have some differences in their functioning as well, both during and after a takeover

During the process of takeovers, although both organs have information rights, detailed procedures are provided in Germany to guarantee that the works council is informed timely and sufficiently. For instance, if the information about a takeover is inadequate or not provided in good time by the employer, the works council is entitled to refer the matter to the conciliation committee,⁵⁷⁶ “a works constitution body which handles and mediates in-house disputes”.⁵⁷⁷ In addition, in companies with over 1000 permanent employees, reports to the staff must be given in writing. In contrast, China does not have such detailed rules on how the Workers' Congress should be informed or any consequences should the employer fail to fulfil their obligation. Therefore, in general, the works council has strong and exercisable rights as compared to the Workers' Congress.

After the completion of a takeover, the works council has co-determination power over a wide scope of matters. These include social matters, such as deciding the working hours, job remunerations and bonuses, and rules of operation and conduct of the employees.⁵⁷⁸ The right of co-determination also includes structural changes that may burden the employees, such as changes in jobs, operations, or the working environment, or even staff movement and dismissal.⁵⁷⁹ In contrast, the rights of the Workers' Congress are fairly restricted. First, the Workers' Congress does not have the right of co-determination in any aspect of employee arrangements. The employer is merely required to inform and consult the Workers' Congress on matters related to employee interests,⁵⁸⁰ with no expectations about when and how to fulfil this obligation. In addition, the Workers' Congress is not involved in employee movement or dismissal, unless there is a mass layoff of at least 10% of all employees, in which case the

⁵⁷⁶ Section 109 of the *Works Constitution Act* (2017).

⁵⁷⁷ Federal Ministry of Labour and Social Affairs of Germany, *Co-determination 2019* (2019), available at https://www.bmas.de/SharedDocs/Downloads/EN/PDF-Publikationen/a741e-co-determination.pdf?__blob=publicationFile&v=2.

⁵⁷⁸ Section 87 of the *Works Constitution Act* (2017).

⁵⁷⁹ Section 91, 99, and 102 of the *Works Constitution Act* (2017).

⁵⁸⁰ Article 13 of *Democratic Management Provisions*.

employer is obliged to consult the congress.⁵⁸¹ This comparison shows that the Workers' Congress does not have supervision rights as strong or well-formulated as its German counterpart for restructuring a firm after a takeover. The Workers' Congress did have a high degree of participation in corporate management in the old planned economy; however, these rights were reduced upon the introduction of the modern corporate governance system in Chinese firms.

Therefore, although the works council and the Workers' Congress possess similar functions concerning the safeguarding of employees at the establishment level, the former has much more powerful and broader rights than the latter. Based on the comparison of these two organs, this thesis argues three factors cause the ineffectiveness of the Workers' Congress: the composition of the employee representatives, their relationship with the trade union, and their role in the corporate structure. A detailed analysis of these three factors is provided below.

The functions of the Workers' Congress and works council are carried out by employee-elected representatives. Therefore, the composition of the employee representatives considerably affects the effectiveness of these institutions. In Germany, the executive staff are excluded from the works council,⁵⁸² and, therefore, the representatives are entirely comprised of shop-floor employees. In contrast, the Workers' Congress does not prohibit the participation of managerial employees. The proportion of the latter is suggested, rather than required, to not exceed 20% of all the employee representatives.⁵⁸³ This portion of executives in the Workers' Congress tends to compromise the voices of the employees at the establishment level, especially since voting is the primary way of exercising the function of the Workers' Congress.⁵⁸⁴ Further, although voting on important issues is expected to be done through a secret ballot, due to the lack of a monitoring mechanism, most of the votes are cast by a show of hands in practice.⁵⁸⁵ As a result, the presence of the managerial staff may make

⁵⁸¹ Article 41 of the *Labour Contract Law of PRC*.

⁵⁸² Section 5 of the *Works Constitution Act* (2017).

⁵⁸³ Article 9 of *Democratic Management Provisions* and Section 5 of *Works Constitution Act* (2017).

⁵⁸⁴ Article 20 of *Democratic Management Provisions*.

⁵⁸⁵ C. Liu, "The Reflection on Vote by Open Ballot of Employee Representatives" (关于职工代表记名投票表决方式的思考) (2011) 25 *Journal of China Institute of Industrial Relations* (中国劳动关系学院学报) 99.

employees reluctant to protect their interests from the management and shareholders of the firm. This is because of the power held by the management over the salaries and promotional opportunities of the grassroots employees.

The Workers' Congress relationship with the trade union is unlike that of the works council in Germany; this is another factor that leads to the functional ineffectiveness of the Workers' Congress. In Germany, the works council is independent from the trade union, and the two organs cooperatively work towards safeguarding the interests of the establishment-level employees. The trade union is entitled to submit a list of candidates for the representative election but does not have voting rights during the election. The delegates of the trade union are allowed to attend the meetings of the works council but only in an advisory capacity;⁵⁸⁶ i.e. the works council is supposed to gain the support of, rather than rest upon, the trade union. In contrast, the Workers' Congress heavily depends on the trade union. This is because the meetings of the Workers' Congress are organised by the trade union, and the trade union is responsible for overseeing the management on behalf of the employees and implementing the decisions of the Workers' Congress. In theory, the trade union is expected to safeguard employees' interests as its leadership of the Workers' Congress should boost the latter's capability to express the needs of the employees. However, due to the trade union's dependence on the management as well as the party-state in China, the trade union is perceived as a channel that connects the employees, management, and party-state.⁵⁸⁷ As a result, the decisions of the Workers' Congress are likely to be compromised by the interests of the firm and the party-state.

The relationship of the Workers' Congress with the trade union affects its role in the corporate structure of Chinese companies, and this is the third factor that causes this organ's ineffectiveness. In Chinese firms, the Workers' Congress is supposed to be the organ that specifically supervises labour affairs on behalf of the employees. However, due to its inferior role to the trade union and the latter's close relationship with the management and party-state, this supervisory role tends to be formalistic. Along with

⁵⁸⁶ Section 2, 14, 16, 31 of *the Works Constitution Act* (2017).

⁵⁸⁷ General Provisions of the *Trade Union's Chapter* (《中国工会章程》) (2013).

the trade union, it tends to be a platform for the management and party-state to relieve themselves from intense conflicts with the workers, and thereby bring benefits to the firm. This is evidenced by statistics showing that the Workers' Congress mechanism mitigates employees' dissatisfaction towards the management and helps internally resolve their disputes with the firm, thereby preventing lawsuits.⁵⁸⁸ Admittedly, the dispute-resolving function of the Workers' Congress does not contradict with its major objective of representing the workers' needs. This is because in firms where the employees' views are expressed and respected, discontent and anxiety are expected to reduce, thereby leading to fewer labour–capital conflicts. However, their intimate relationship with the party-state and management makes the Workers' Congress deviate from their standing with the workers. Labour protection problems may be raised when the workers' interests are subject to the party-state's overall considerations. For example, in the case of the takeover of Tuopai Shede Wine Co. Ltd in 2016, the Workers' Congress was complacent about the harm caused to the interests of labour because the takeover was a decision made by the party-state.⁵⁸⁹ It should be noted that works councils in German enterprises also maintain a sound relationship with the management for the good of employees.⁵⁹⁰ The benefits are two-fold: First, the managerial staff facilitate the workers' comprehension of the targets, actions, expectations, and employees' role in implementing the policies and decisions of the management; Second, the management have access to the first-hand operational knowledge of the shop-floor workers⁵⁹¹ as well as their attitudes towards certain corporate decisions; thus, the workers' opinions are more likely to be considered during the managerial decision-making process.⁵⁹² In general, the works council aims to achieve industrial peace and is equipped with various mechanisms to oppose the management if the latter hurts labour interests. Unlike the Workers' Congress, the works council is independent from the management board, the trade union, and other institutions that may affect its position to protect labour interests. As a result, the works

⁵⁸⁸ J. Zhan, X. Li, and T. Yang, "Can the Workers' Participation Mechanism Relieve the Conflicts between the Capital and the Labour" (企业员工参与制度有助于劳资纠纷内部消解吗) (2016) 18 *China Human Resource Development* (中国人力资源开发) 68.

⁵⁸⁹ Sina Finance (n 332).

⁵⁹⁰ Section 2 of *the Works Constitution Act* (2017).

⁵⁹¹ Fauver and Fuerst (n 250).

⁵⁹² S. Brezezinski and A. Bak, "Management of Employees' Commitment in the Process of Organization Transformation" (2015) 27 *Procedia Economics and Finance* 109.

council collects the workers' views, conveys them to the employer, and oversees the corporate management exclusively on the behalf of the workers. Meanwhile, it acts as the employee representative and helps the management make decisions that seriously consider the employees' interests. In addition to the supervisory function, the works council is a co-decision-making organ for various labour affairs. The works council plays a significant role as the decisive power in German corporate structures in comparison to its Chinese counterpart.

Thus, the position of the Workers' Congress in Chinese firms is prejudiced towards the management rather than the workers. In addition, the works council has broad and powerful rights as compared to the Workers' Congress against labour issues. However, whether such strong rights would be conducive to the party-state, the firm, as well as the employees requires further exploration to adapt the works council model to firms in China, and this is examined in the next section.

5.2.3 Conclusion

Although Chinese firms have their respective counterparts to the German co-determination institutions, a lack of detailed rules make the former much less effective. Another reason for their relative ineffectiveness is their structural arrangement. The trade union in Chinese firms is the core organ in the worker representation system both at the board and establishment levels. On the one hand, it has a *de facto* decisive say over the election of the employee representatives on the BoS due to its nomination rights. On the other hand, it exerts a considerable the amount influence over the Workers' Congress by organising and leading its work. Considering the party-state's leadership over the trade union and its influence in corporate decision making, the effectiveness of the worker representation mechanisms in Chinese companies rests upon on the incentives of the management as well as the party-state. In contrast, the core institution of the German co-determination mechanism is the works council, which represents the workers at the establishment level and elects their representatives to the supervisory board. Unlike the trade union in China, the works council is

insulated from any external influences, which guarantees its effectiveness in representing the workers.

5.3 The Ideologies underlying the Chinese and German Employee Participation Mechanisms

Having examined the differences between the worker representation mechanisms of China and Germany, we now examine the deeper reasons for these differences by understanding each country's law-making ideologies in this section.

The idea of examining the backgrounds to these work representation mechanisms arises from the path dependency theory, which explains the persistent power of idiosyncratic corporate structures and rules in different economies operating against the worldwide tendency towards convergence in corporate governance.⁵⁹³ One reason for such persistence is that the corporate rules are embedded in the respective political and social settings that reflect the relevant strength of the interest groups, which in turn deepens their entrenchment. Along with these corporate rules, the underlying ideologies tend to persist and have profound impacts on each amendment of the laws, including the current work representation mechanisms in Germany and China. As a result, to further test whether the German co-determination system can be adapted to the Chinese economy, it is necessary to identify the ideologies underlying these rules by analysing their social, institutional and political settings.

5.3.1 The Ideologies underlying the Workers' Congress in Chinese Firms

The history of the Workers' Congress in China was briefly introduced in section 3.2.2. This part focuses on the major objectives of the Workers' Congress in the old planned economy. While the Workers Congress' primary role "on the books" is to represent

⁵⁹³ Bebchuk and Roe (n 18).

the workers, its objectives “in action” are closely connected with the party-state and its political purposes.

The ideologies of the Workers’ Congress can be examined from two aspects. The first is from the needs to reduce the agency costs. The Workers’ Congress role was to oversee the factory directors, which reduced the costs of the party-state in managing the state-owned enterprises in the socialist economy. As mentioned in section 3.2.2, the factory director managed the factory on behalf of the party-state. Therefore, the party-state needed a supervisory organ internal to the enterprise to reduce the agency costs incurred by pervasive problems such as tunnelling or bribery of the factory directors.⁵⁹⁴ However, this function gradually became obsolete with the introduction of the modern corporate system, and the BoS began to act as the major supervision organ in the 1990s. Since then, this supervisory role was replaced by the workers’ compulsory participation on the BoS. The second aspect goes beyond corporate governance to the party’s ruling of the country. This can be explained using the political settings of three milestones during the development of the Workers’ Congress. The first milestone is traced back to the founding of the People’s Republic of China. The workers’ interests were expected to align with those of the party-state, as the “masters” of the country,⁵⁹⁵ and their mission was to support the latter in economic recovery from economic prostration after the war. The party-state engaged in restoring the Chinese economy to the normal working order.⁵⁹⁶ Therefore, in addition to safeguarding labour interests, the Workers’ Congress was committed to encouraging the workers’ initiatives in production on behalf of the party-state.⁵⁹⁷ The second milestone was reached in the late 1980s, when the Workers’ Congress system was confirmed by law. As mentioned in section 3.2.2, this was mainly due to the impact of the “Polish Crisis”, when workers were organised to rebel against the communist regime in Poland in the 1980s. The Chinese communist party analysed the main

⁵⁹⁴ Z. Ding, “From Bribery to Capital flight: Some Thoughts on the Loss of State Assets” (从腐败到资金大外逃—对于国有资产流失的几点思考) (2000) 1 *Modern China Studies*, available at <http://www.modernchinastudies.org/us/issues/past-issues/68-mcs-2000-issue-1/529-2012-01-03-12-11-40.html>.

⁵⁹⁵ ACFTU (n 305).

⁵⁹⁶ S.G. Zhang, *Economic Cold War: America’s Embargo Against China and the Sino-Soviet Alliance: 1949-1963* (Stanford University Press-2001) 50.

⁵⁹⁷ Y. Zhang, “The Relations between the Trade Union and the Party-State” (中国工会与党—国家的关系) (2003) 18 *21st Century* (二十一世纪), available at <http://paper.usc.cuhk.edu.hk/Details.aspx?id=2574>.

reasons for the communist crackdown in Poland, one of which was a lack of democratic mechanisms for workers to consult with the party-state. In order to solidify the ruling of the party-state, the role of the mechanism of the Workers' Congress in Chinese firms was re-emphasised and strengthened by the party-state.⁵⁹⁸ It should be noted that during the same period, China was undergoing the reform of the economic system, which included a change of labour policies. In 1986, the employment contract regime was introduced to China,⁵⁹⁹ which was deemed to fundamentally change the workers' relationship with the firm.⁶⁰⁰ Starting from then, Chinese workers started to lose their life-long employment and was exposed to the risks of being dismissed. In addition, some social welfare programs such as housing, education, and healthcare were gradually separated from the economic activities of SOEs. Accordingly, in order to alleviate workers' unrest arising from this sudden loss of job stability and welfare, the unemployment insurance was introduced, and the Workers' Congress mechanism was revived. The third milestone was reached in the early 2000s, when the workers were endowed with certain co-determination rights in the context of the SOE reform. The traditional SOEs had long been criticised as low on efficiency compared to private enterprises. As a result, the government decided to enhance the competitiveness of the state industries through firm exit or the restructuring of firms,⁶⁰¹ both of which led to mass redundancies. Despite the confirmation of the Workers' Congress mechanisms, this organ remained silent in the face of the huge lay-offs on administrative orders. This indicates that the Workers' Congress is subject to the party-state's political objectives. On the other hand, most lay-offs are senior workers who had developed a high degree of firm-specific skills. These could not be transferred to other workplaces and job profiles. Furthermore, the laid-off workers usually lacked educational credentials and were thereby marked as unskilled. As a result, they found it difficult to compete with the labour market and make a living after their dismissal. The need for the state to improve the efficiency of the SOEs conflicted with labour welfare, leading to various social problems such as unlawful protests and violence against the

⁵⁹⁸ Wilson (313) at 259.

⁵⁹⁹ The State Council of PRC, *Provisional Regulations on the Implementation of the Labour Contract System in State-Owned Enterprises* (《国营企业实行劳动合同制暂行规定》) (1986).

⁶⁰⁰ K. Ngok, "The Changes of Chinese Labor Policy and Labor Legislation in the Context of Market Transition" (2008) 73 *International Labor and Working-Class History* 45.

⁶⁰¹ W. Hurst, *the Chinese Worker after Socialism* (Cambridge University Press-2009) 53.

management of the enterprises.⁶⁰² Due to this, the co-determination power of the Workers' Congress was introduced to alleviate the serious conflict between the interests of labour and the state by formulating a plan for employee arrangements satisfactory to both parties. Thus, in addition to its basic function of protecting the employees' interests, the Workers' Congress is perceived as a tool for the party-state to achieve its political objectives, such as economic development and the maintenance of social stability, as mentioned above. As a result, whether employees can effectively express their issues to the management board of the enterprises through the Workers' Congress depends on whether labour interests are prioritised during policymaking by the party-state. Therefore, Chinese mechanisms lack detailed rules, making the mechanism non-transparent and unpredictable to facilitate the implementation of the party-state's political policies, since the labour force may occasionally be deemed to be a barrier of their fulfilment.

The Workers' Congress system that originated in the old planned economy was approved by the Chinese laws and is accordingly applied to private firms. Similar to the SOEs, the Workers' Congress in private firms depends on the party-state to fulfil its information and participation rights during takeovers. However, unlike the SOEs that are frequently used to achieve political objectives, private firms in China are the major source of the market force that contributes towards China's economic growth.⁶⁰³ As discussed in Chapter Two, a moderate degree of workers' participation positively relates to the firm value. Therefore, to improve the effectiveness of the Workers' Congress aligns with party-state's present needs as well as its expected future needs.

5.3.2 The Ideologies underlying the German Co-determination Mechanism

The co-determination system present in Germany allows workers to strongly affect the corporate governance of their respective firms. The labour participation ideas first

⁶⁰² A. Liu and P. Wang, "An Analysis of the Lay-offs' Choice of Actions: Taking Xiamen for Example" (下岗、失业工人的行动选择分析: 以厦门市调查为例) (2005) 209 *Journal of Fujian Party School* (中共福建省委党校学报) 37.

⁶⁰³ Lardy, *Markets over Mao* (n 393).

appeared in publications as early as 1834, and the detailed and generally applied co-determination mechanism was codified by the Co-determination Act in 1976.⁶⁰⁴ This section attempts to examine the reasons for the origin and underlying ideologies of the co-determination system in Germany to assess the extent to which it would be feasible to adapt it to the Chinese economy.

The first reason is attributed to the spirit of social democracy, mutuality, and equality being prevalent in German society.⁶⁰⁵ Democracy can be explained using the worker' participatory scheme in the context of corporate governance. The rationale was that if the owners of the firms reserved all the decision rights, they must bear all the losses. However, workers also suffered from such losses and, therefore, it was stated that workers should be allowed to participate in corporate decisions.⁶⁰⁶ Although these values are observed in China, exemplified by the democratic system of allowing workers' representation on the boards, the party-state has retained its paternalistic control throughout the history of the Chinese economy. Hence, the extent to which these values are emphasised depends on the party-state's willingness to do so, and these values are not rooted in the society.

The second reason is the trade union's independence from any external institution, which was conceived as the basis for the establishment of the co-determination mechanism. The employee representation in German enterprises originated from collective agreements based on the industrial culture of democracy, mutuality, and equality between the employees and employers. Such values were largely promoted by the German trade unionists, and, accordingly, the codification of labour co-determination was regarded as an achievement of the trade union movement. The trade unions in Germany were fairly active and able to exert pronounced influences on labour protection. This strong power resulted in the trade unions' complete independence and position of exclusively serving labour interests.⁶⁰⁷

⁶⁰⁴ H. Teuteberg, *Geschichte der Industriellen Mitbestimmung in Deutschland* (Tubingen-1961).

⁶⁰⁵ R. Lewis and J. Clark, 'Introduction' in O. Kahn-Freund, *Labour Law and Politics in the Weimar Republic* (Blackwell-1981)7.

⁶⁰⁶ E.C. McCreary, "Social Welfare and Business: The Krupp Welfare Program, 1860-1914" (1968) 42 *The Business History Review* 31.

⁶⁰⁷ H.A. Clegg, *A New Approach to Industrial Democracy* (Blackwell-1960) 22.

The third reason is that the co-determination system arose from the belief that a deeper involvement of workers in factory management would increase production, which aligned with the employers' interests.⁶⁰⁸ The co-determination mechanism was first introduced by the factory owners, rather than the trade unions, on a voluntary basis.⁶⁰⁹ Although such an alignment was widely questioned by scholars,⁶¹⁰ the labourers' participation in management positively affected economic development in certain historical periods. For instance, the resurrection and development of labour participation coincided with the country's urgent need for economic recovery. Recent studies have confirmed the individual employer's embrace of this belief as well as the cooperation between capital and labour in management.⁶¹¹ However, there is no denying the fact that the labour co-determination system was highly controversial and was forced to confront a series of problems upon introduction. This is illustrated by the reluctance of other jurisdictions, such as the UK, to adopt this mechanism after intense debates over its advantages and disadvantages.⁶¹² For instance, the trade unionists in the UK thought that the workers' participation on the board might make the trade union indistinguishable from the management, thereby restricting the trade union's capacity to engage in collective bargaining.⁶¹³ Even in Germany, lawmakers found it difficult to draw up laws compatible with the German company laws.⁶¹⁴ This was because Germany company laws prioritised shareholders' interests, but the parity of worker's representation on the supervisory board prejudiced the shareholder's final right of decision. Further, the secrecy of the members on the supervisory board was

⁶⁰⁸ E.G. Furubotn, "Co-determination, Productivity Gains, and the Economics of the Firm" (1985) 37 *Oxford Economic Papers* 22.

⁶⁰⁹ E. McGaughey, "The Co-determination Bargains: The History of German Corporate and Labour Law" (2015). *LSE Law Society and Economy Working Papers* 10/2015, available at <http://eprints.lse.ac.uk/61593/1/The%20codetermination%20bargains%20the%20history%20of%20german%20corporate%20and%20labour%20law.pdf>.

⁶¹⁰ M.C Jensen and W. Meckling, "Rights and Production Functions: An Application to Labor-Managed Firms and Co-determination" (1979) 52 *Journal of Business* 469 at 473. They "suggest that co-determination or industrial democracy is less efficient than the alternatives which grow up and survive in a competitive environment."

⁶¹¹ T. Paster, "Do German Employers Support Board-level Co-determination? The Paradox of Individual Support and Collective Opposition" (2012) 10 *Socio-Economic Review* 471.

⁶¹² R. Zahn, "German Co-determination without Nationalization, and British Nationalization without Co-determination: Retelling the Story" (2015) 36 *Historical Studies of Industrial Relations* 1.

⁶¹³ N. Chester, *The Nationalisation of British Industry* (HMSO-1975) 844.

⁶¹⁴ W. Kolvenbach, "Co-determination in Germany: History and Practical Experience" (1981) 9 *International Business Lawyer* 163.

thought to conflict with the obligations of the worker and trade union representatives to safeguard the interests of labour.

To summarise, three reasons for the effectiveness of German co-determination mechanism have been identified in comparison to Chinese contexts. The first is the complete independence of the trade union, which was the main driving force behind this system. The second is the long-standing belief that workers' deeper involvement in management aligns with the shareholders' interests, although this was largely questioned by academics when the system was first proposed.

5.3.3 Compromising Ideologies

The German and Chinese labour participation mechanisms are shaped by different ideologies, and this may be an obstacle to Chinese firms adopting the German co-determination mechanism. As evidenced by the history of the German system, it would be a challenge for workers to obtain co-determination rights without the support of completely independent trade unionists. This is especially the case in China as industrial relations are managed by the party-state, which in turn affect corporate decisions. This dependence on the party-state may compromise the position of the trade union and Workers' Congress as the representatives of the workers. On the other hand, Chinese workers may gain advantages, as compared to their German counterparts, in obtaining and exercising their co-determination rights, as explained below.

First, the German co-determination mechanism can only be introduced if it is supported by the party-state. This is because the party-state is the driving force behind the law-making system and retains control over the market. Although the political process of law-making has become "more consultative and sophisticated, and political actors more diversified and competitive",⁶¹⁵ the party-state continues to have the

⁶¹⁵ Y.N. Cho, "The Politics of Lawmaking in Chinese Local People's Congress" (2006) 287 *The China Quarterly* 187.

leading role in the rule-of-law regime.⁶¹⁶ Therefore, without the permission of the party-state, the German co-determination mechanism cannot be introduced in China.

Second, the party-state can alleviate this imbalance of power and, thus, make workers exercise their rights in a more effective manner. The party-state can persuade or occasionally force the employer to provide employees with co-determination rights during takeovers due to its command over the Chinese market and influence in corporate decision making. For instance, the employer is less likely to disobey the party-state's instructions to improve the employees' roles in the takeover decision-making process. Hence, workers' information and participation rights are more likely to be safeguarded under the supervision of the party-state.

Third, the operation of the co-determination mechanism would be more effective and streamlined with the party-state's leadership as the party-state can intervene when the workers' information or participation rights are infringed by the employer.⁶¹⁷ Additionally, since Chinese workers have relied on the party-state to safeguard their legitimate interests throughout history, they may lack adequate resources and capabilities to uphold their co-determination rights, making them vulnerable to unjust treatments by the management during takeovers. Therefore, with the solid support of the party-state, workers would be more capable of protecting their rights and bargaining with the employer.⁶¹⁸

However, as mentioned above, this mechanism was initially adopted by some German firms on a voluntary basis. This gives rise to the question of whether Chinese firms would voluntarily choose to follow this system; this may not be feasible in the Chinese economy for three reasons.

⁶¹⁶ S. Trevaskes, "China's Party-led Rule-of-law Regime" (2017), available at <http://www.eastasiaforum.org/2017/10/02/chinas-party-led-rule-of-law-regime/>.

⁶¹⁷ J. Zhang and W. Xu, *Towards Negotiations: Empirical Exploration of the Trade Union in China* (走向谈判: 中国工会的实践探索) (Xinhua Publishing House-2014).

⁶¹⁸ B. Bai, "The Compatibility of the Trade Union Accepting the Leadership of the CPC with its Performing Functions Independently and Creatively" (工会自觉接受党的领导与独立自主创造性工作统一关系思考) (2010) 24 *Journal of Institute of Industrial Relations* (中国劳动关系学院学报) 35.

First, the adoption of the co-determination mechanism would bring relatively few benefits to the individual employees at a loss to managers due to their having less leeway for opportunistic managerial behaviours. Due to the lack of information and collective action problems, shareholders can hardly insist on the co-determination mechanism against entrenched managerial opposition.⁶¹⁹ Therefore, the resistance to the introduction of an employee participation scheme is strong. To benefit both shareholders and employees as well as positively affect the Chinese economy and its innovative capabilities, the party-state needs to be the driving force that adapts this system to the Chinese laws.

Second, China lacks independent workers' organisations that can support the adoption of the German co-determination system. By understanding that the Chinese trade unions are not equipped to represent the interests of the employees, an increasing labour non-governmental organisation (NGO) with the objective of protecting the interests of employees emerged.⁶²⁰ However, these organisations have weak voices, and, more importantly, labour organisations other than the trade unions are prohibited by Chinese law.⁶²¹

Third, the paternalistic style of leadership that is rooted in Chinese culture is opposed to the values of democracy, mutuality, and equality that guided Germany's path to co-determination. In China, the party-state is, similar to the patriarch of a family, expected to control as well as provide care and protection for its subordinates, while the subordinates, in return, are expected to be loyal and obedient to their superior.⁶²² One noticeable consequence of this leadership style is the inequality of power between the party-state and workers. In particular, workers give up their rights to exercise autonomy and choice⁶²³ to the party-state in return for corporate decisions that favour employees. The party-state is expected to determine the wants and needs of the

⁶¹⁹ Smith (n 266).

⁶²⁰ According to a survey, as of 2013, there were more than 50 labour organisations in China. Starting from 2007, an increasing number of labour NGOs have been repressed by the local government. See Xu (n 331) at 246.

⁶²¹ Article 2 and 4 of the *Trade Union Law of PRC*. Some labour NGOs were repressed by the local government from 2007. See Howell (337).

⁶²² Z. Aycan, "Paternalism: Towards Conceptual Refinement and Operationalization" in U. Kim, K. Yang, and K. Hwang (eds), *Indigenous and Cultural Psychology: Understanding People in Context* (Springer-2006) 445.

⁶²³ H. Blokland, *Freedom and Culture in Western Society* (Routledge-1997).

employees but not on a reciprocal basis.⁶²⁴ However, evidence shows that workers tend to remain silent when unfavourable corporate decisions are made under the paternalistic leadership⁶²⁵ for various reasons, including the fear of retaliation or punishment from management⁶²⁶ and the shared belief that defying the decisions made by their superiors is not worth the effort as their suggestions would not make a difference.⁶²⁷ Therefore, workers are inclined to withhold their opinions from the party-state even when the decision would harm their interests. Due to this, the party-state, and not the employees, needs to be the driving force that introduces the German co-determination mechanism in China.

As analysed in Section 2.2 and Section 5.3.1, the improvement of workers' involvement in takeover decisions aligns with the interests of the firm as well as the party-state. This echoes the ideology underlying the German co-determination mechanism, which furthers the party-state's incentive to introduce this system in Chinese firms. Although Chinese firms and their German counterparts have institutional and cultural differences, the establishment of the co-determination mechanism would be feasible with the support of the party-state. However, whether this system can be introduced and implemented effectively depends on how it can be adapted into the Chinese legal system, and this is analysed in the next chapter.

5.4 Conclusion

This chapter provided an introduction to the German co-determination mechanism at the board and establishment levels. Compared to their Chinese counterparts, German workers have stronger rights that enable them to effectively participate in corporate management and make decisions on issues relating to their interests. These advantages

⁶²⁴ J. Farh, J. Liang, L. Chou and B. Cheng, "Paternalistic Leadership in Chinese Organizations: Research Progress and Future Research Directions" in C. Chen, *Leadership and Management in China*. (Cambridge University Express-2010) 171.

⁶²⁵ J. Duan, C. Bao, C. Huang and C.T. Brinsfield, "Authoritarian Leadership and Employee Silence in China" (2018) 24 *Journal of Management and Organisation* 62.

⁶²⁶ F.J. Milliken, E.W. Morrison, and P.F. Hewlin, "An Exploratory Study of Employee Silence: Issues that Employees Don't Communicate Upward and Why" (2003) 40 *Journal of Management Studies* 1453.

⁶²⁷ E.W. Morrison and F.J. Milliken, "Organizational Silence: A Barrier to Change and Development in a Pluralistic World" (2000) 25 *Academy of Management Review* 706.

are attributed to two factors: 1) German firms have powerful and independent trade unions; and 2) the values of democracy, mutuality, and equality are prevalent. These two factors are not observed in China due to the dominance of the party-state over the Chinese economy. The party-state can exercise its discretion over the extent to which workers can be involved in corporate management. Due to this, firms cannot be expected to voluntarily establish the co-determination mechanism, especially considering the paternalistic style of leadership followed in China. Therefore, the party-state needs to establish rules of co-determination specific to China. With the strong support of the party-state, this scheme would be adopted and enforced in firms. The addition of explicit rules to limit the party-state's discretionary behaviours would help to change the level of workers' participation in corporate management.

Having identified the differences between the Chinese and German employee participation mechanisms and the ideologies underlying these systems, the next chapter of this thesis explores how the German system can be adapted into the Chinese economy.

Chapter 6: The Co-Determination Mechanism in Chinese Takeovers

This chapter aims to present how the German co-determination mechanism can be adapted to Chinese firms. However, adapting the entire German co-determination mechanism to Chinese firms is beyond the scope of this thesis. Instead, based on the German scheme, I suggest ways to improve workers' participation levels during takeovers to better safeguard their interests in China. As analysed in Chapter 5, German workers' co-determination rights are reflected at both the board level and the establishment level. The former focuses on the employees' involvement in takeover decisions, whereas the latter focuses on safeguarding the interests of immediate concern to the workers. Options for reforms at the two levels in Chinese firms are explored based on the German mechanism. Considering that the German system emerged under wholly different historical, cultural, economic, and legal contexts, the introduced system may have certain side effects in addition to the improvement of workers' participation level in the context of takeovers. One is that the corporate governance model of shareholder primacy, which Chinese firms widely adopt, is expected to be more stakeholder oriented. This change in ideology is able to provide theoretical foundation for the suggested mechanism, and therefore, that is first examined in this chapter. Other factors in Chinese contexts may affect the extent to which the introduced model can be accepted and is effective. This is expected to affect the feasibility of the suggested system in the context of hostile takeovers. Accordingly, after the details of the suggestions for deeper workers' involvement are provided, the feasibility of the directions for reform is examined.

6.1 The Ideology underlying the Suggested Mechanism: from the Perspective of the Model of Corporate Governance

As examined in section 2.1, corporate governance models that pose a challenge to shareholder primacy provide the theoretical foundation for employee claims to be taken into consideration. Depending on the extent that shareholders and stakeholders

are granted a voice in corporate governance these corporate governance models constitute a spectrum, wherein shareholder primacy and stakeholder theory lie at the poles and ESV is somewhere between them. As analysed in section 1.3, this thesis presents that the corporate governance model that Chinese legislators choose is shareholder primacy. Meanwhile, although German corporations have different development paths from these models in the Anglo-American tradition, it is generally agreed that they adopt a stakeholder approach of German style, which is characterised by two features.⁶²⁸ First, as described in section 4.3, due to the stable role of banks in providing external corporate finance and acting as long-term investors, the objective of management in German firms is focusing on firms' long-term value. This requires the management to consider stakeholders' interests, which is different from the model of shareholder primacy that focuses on the short-term gains of investors. Second, the German co-determination mechanism provides employees with extensive participation rights in corporate decision making and in affairs that directly relate to workers' interests. In this regard, the application of the German co-determination scheme to Chinese firms in the context of hostile takeovers is expected to make the ideology of corporate governance in Chinese firms move away from shareholder primacy and towards stakeholder theory in the spectrum of the corporate governance models. Before suggesting the co-determination scheme in hostile takeovers of Chinese styles, it is necessary to identify the location of its underlying ideology on which the model is based.

In order to achieve this objective, three questions must be addressed. The previous chapters have provided clues for the answers, so these questions are explored briefly here. The first is whether shareholders' interests should be prioritised to the point of exclusion of other stakeholders' interests as in the shareholder primacy. This question has been answered in Chapters 1 and 2; workers are vulnerable to adverse treatments in hostile takeovers and their claims must be considered to positively affect firm value. In this regard, compared to shareholder primacy, the suggested model should be stakeholder oriented.

⁶²⁸ G. Jackson, M. Hopner, and A. Kurdelbusch, "Corporate Governance and Employees in Germany: Changing Linkages, Complementarities, and Tensions" (2004) *RIETI Discussion Paper Series 04-E-008*, available at <https://www.rieti.go.jp/jp/publications/dp/04e008.pdf>.

The second is whether employees should have any decisive say over takeover decision making, which is required by stakeholder theory. The answer is also negative. Hostile takeovers are particularly perceived as the most powerful mechanism for shareholders to discipline underperforming executives,⁶²⁹ which arises from shareholders' ability to freely transfer their shares. In this regard, if workers are endowed with the co-decision power, the emergence of a hostile takeover will be hindered because developing a takeover plan satisfactory to workers is time-consuming and costly and may also lower the corporate raider's intention to acquire the target firm. In addition, giving workers this co-decision right is unrealistic; as described in Chapter 1, hostile takeovers are normally achieved by tender offers step by step, and it is unreasonable for workers to reject the share sale on behalf of shareholders. Therefore, even in Germany, which is widely deemed to adopt a stakeholder approach, workers do not have the decisive say in takeover decisions.

Thus, the introduced German mechanism is closer to ESV, which take employee claims into consideration for the benefit of the firm's long-term value. Specifically, in takeovers in the UK that adopt the ESV model, the board of the target firm should send a circular to shareholders and others with information rights, which include the opinion of the board on the offer and advice from the independent advisor. It should be noted that Chinese laws have similar requirements as introduced in section 1.1. However, differently, in the UK, the opinions of employee representatives should be appended to the circular of the target board,⁶³⁰ which is similar to the German rule. It is reasonable that the takeover rules in both countries are influenced by the EU directive on takeovers.⁶³¹ However, compared to the UK rules, the German ones have more details to procure the opinions of employee representatives can reflect workers' voices. This can be evidenced by the vague definition of employee representatives in the UK, which do not require shop-floor employees to be chosen as the representative.⁶³²

⁶²⁹ J.A. Pearce II and R.B. Robinson JR, "Hostile Takeover Defenses that Maximize Shareholder Wealth" (2004) 47 *Business Horizons* 15.

⁶³⁰ Rule 25 of the *City Code*.

⁶³¹ See European Union, *Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids* (2004).

⁶³² Definitions of the *City Code*.

Compared to the ESV which is represented by UK law, the proposed German mechanism can express the workers' voice better, as detailed rules leave less room for the personal discretion of executives. Therefore, in the spectrum of corporate governance models, the suggested German model is close to ESV, but compared to the latter, it is slightly more stakeholder oriented.

It should be noted that the introduction of the German system in the context of hostile takeovers cannot make a difference to the model of shareholder primacy that Chinese firms have adopted in the landscape of corporate governance. This is especially the case considering that although the number of hostile takeovers is expected to increase, they are still rare in the life circle of a corporation. Such modifications of ideology in this context only aim to alleviate workers' vulnerability to adverse treatments and promote a firm's long-term value. After identifying the ideology, the details of the suggested scheme are provided in the next two sections.

6.2 Employee Participation at the Board Level

Three benefits of worker's representation at the board level have been highlighted in the previous chapters. First, these members are able to directly represent workers during the takeover decision-making process, which is conducive to employee protection. Second, it provides the management and shareholders with shop-floor knowledge and information, which may enhance the quality of the takeover decisions. Therefore, "discussions in the boardroom on issues affecting the choices and alternatives can now be better controlled and rational decision-making is thus facilitated".⁶³³ Third, higher levels of workers' participation in corporate decision making are expected to improve production and positively affect the firm's value. However, due to the ineffectiveness of employee representation on both the BoD and BoS, these benefits are not being obtained, which indicates the need for a reform of the ways in which employee representatives perform their functions.

⁶³³ C.L. Citroen, "The Role of Information in Strategic Decision-making" (2011) 31 *International Journal Information Management* 493.

It should be noted that employee representatives are present on the BoD as well as the BoS, both of which involve legitimate opportunities to participate in the takeover process. However, compared to the BoD, the BoS is the ideal institution for workers to exercise their co-determination rights in, and this section begins with an analysis of the reasons underlying this choice. It then moves on to explore possible solutions to Chinese problems based on the selective adaptations of features of the German system.

6.2.1 Worker Representation on the BoS and BoD

In German companies, workers participate in corporate management through their representatives on the supervisory board. Therefore, it may seem natural to focus on the employee representation mechanism of the BoS in Chinese firms to improve employees' involvement in takeover decisions. However, this would be far too hasty a conclusion to make, especially considering that the German supervisory boards retain some responsibilities that, according to Chinese laws, should belong to the management board. In particular, the supervisory board in Germany is required to participate in making management decisions of fundamental importance to the firm,⁶³⁴ especially the initiation of takeover defence tactics.⁶³⁵ The practical difficulties involved in distinguishing between the managerial and supervisory functions⁶³⁶ have induced a debate among Chinese scholars over whether the German BoD or BoS can be deemed as the counterpart of the supervisory board in Chinese firms.⁶³⁷ Hence, we explore this choice between the BoD and BoS in this thesis with the aim of increasing workers' involvement in takeover decisions.

We do not aim to adapt the entire co-determination mechanism to the Chinese corporate governance for this thesis, especially considering that the German system has its own defects, as noted by scholars.⁶³⁸ Accordingly, one of the objectives of this

⁶³⁴ 5.1.1, *the German Corporate Governance Code* (2017).

⁶³⁵ Section 33a of the *Securities Acquisition and Takeover Act* (2011).

⁶³⁶ J. Du Plessis, "The German Two-Tier Board and the German Corporate Governance Code" (2004) 15 *European Business Law Review* 1139.

⁶³⁷ P. Jiang, "Talks on the Amendments of the Company Law" (纵论公司法的修改) (2005), available at http://old.civillaw.com.cn/article/default.asp?id=23368&d_id=04f321303ee4beb0ae09f2e144f30a.

⁶³⁸ V. Carrasco, "Corporate Board Structure, Managerial Self-Dealing, and the Common Agency" (2006) *Stanford Institute for Economic Policy Research SIEPR Discussion Paper No.04-15*, available at

thesis is to solve Chinese problems without significant changes to the current corporate laws. From this perspective, improving the effectiveness of worker representation on the BoS has practical advantages compared to the BoD, as explained below.

According to Chinese laws, a third of the BoS is required to be filled by employee representatives. In contrast, the same system is merely encouraged for the BoD of private firms.⁶³⁹ Due to the ineffectiveness of the latter system, as analysed in section 3.4, reforming the BoD would involve much higher costs because it would require establishing a compulsory workers' representation mechanism beforehand, and whether this system is feasible is still under exploration by the party-state. Additionally, a takeover is a complex process which is normally accompanied by long term procedures and negotiations with the acquirer. Resistance to the potential takeover by the BoD would lead to further complications between the acquirer and the target firm.⁶⁴⁰ Such a scenario would require the involvement of directors with high management capabilities and experience as employee representatives, which is a challenge in private firms. In contrast, for members on the BoS who are not necessarily engaged in every step of the takeover process, this qualification is relatively lower. According to the Chinese Company Laws, the BoD has a fiduciary duty to the shareholder assembly; this is not the case with the BoS.⁶⁴¹ Accordingly, the role of employees on the BoD is ambiguous since they are required to serve the shareholders as well as employees, the interests of whom may conflict.⁶⁴² However, employee members on the BoS do not share these conflicts of interest. Their representatives have no legal obstacles to safeguarding the workers' interests.

Due to the above reasons, the BoS is the ideal platform to introduce the co-determination mechanism at the board level as compared to the BoD. The above analysis does not aim to deny any positive implications of employee representation on the BoD for safeguarding workers' interests. In addition to direct participation in takeover decisions, employee representatives' resistance on behalf of workers would,

<ftp://ftp.repec.org/opt/ReDIF/RePEc/sip/04-015.pdf>.

⁶³⁹ Article 44 and 51 of *the Company Law of PRC*.

⁶⁴⁰ D. Watson and A. Head, *Corporate Finance: Principles and Practice* (Pearson Education-2010) 332.

⁶⁴¹ Article 46 of *the Company Law of PRC*.

⁶⁴² Hu (n 355).

in general, make it difficult for the acquirer to control the firm, since the representatives would be elected by the Workers' Congress and not the shareholder assembly.⁶⁴³ However, due to their close connections with other members on the BoD, as mentioned in Section 3.4, employee representation on the BoD is normally used by the management as an anti-takeover tactic rather than to safeguard workers' interests. Besides, employee representation on the BoS has its own deficits in safeguarding workers' interests during takeovers. As analysed in Chapters 3 and 4, there are two reasons for these deficits: the representatives are unable to represent the workers' interests; and the BoS cannot actively participate in the takeover decision-making process. In the next section, co-determination at the board level during takeovers is established, particularly in response to these two problems.

6.2.2 The Establishment of a Chinese Co-determination Mechanism in the Chinese Takeover Context

After deciding that the BoS is the platform to introduce workers' co-determination rights during takeovers at the board level, we explore how this system can be adapted into the Chinese legal system in this section. As previously mentioned, obstacles to providing employee representatives with co-determination rights in takeover situations exist at two levels: the institution and individual. This section includes a discussion on increasing the involvement of the BoS in the takeover decision-making process, and then an analysis of the two levels of obstacles.

To Improve Effectiveness at the Institution Level

The first objective of this mechanism is to ensure the free flow of information between the BoS and the BoD, which is also the primary aim of the German co-determination system.⁶⁴⁴ According to German laws, the management board is obliged to report any takeover process to the supervisory board, and members on the supervisory board are

⁶⁴³ L. Song, "Case Analysis of Anti-Takeover of Vanke" (万科反并购案分析) (2017) *Master's Dissertation of Shenzhen University* 31.

⁶⁴⁴ J. Du Plessis, B. Großfeld, C. Luttermann, I. Sawnger, O. Sandrock and M. Casper, *German Corporate Governance in International and European Context* (Springer-2012) 146.

entitled to request information about the takeover at any time. The information provided by the management board is expected to be timely, conscientious, and accurate.⁶⁴⁵ These rules facilitate the flow of information from the management to the supervisory organ, which can be directly adapted to the Chinese laws, especially because there is no explicit rule, at present, to allow the BoS to actively participate in the takeover process. Members on the BoS can also gain information by attending the meetings of the BoD, albeit without voting rights, but, rather than being required by Chinese law, this is merely encouraged. The BoS does not necessarily have to attend all the BoD meetings for daily corporate management, especially for matters beyond the scope of their supervisory responsibilities and role, as excessive supervision over the BoD may impede the latter's efficacy in corporate management.⁶⁴⁶ However, considering the significant changes that can be caused by takeovers, members of the BoS should be required to attend meetings of the BoD to gain information and provide their opinions on the impacts of the potential takeover, and the BoD should not resist this participation. Therefore, the BoS members should be invited to BoD meetings, with a written notice and within a reasonable period prior to the meeting, to vote on matters related to takeovers. The shareholder-elected and employee-elected members should both be required to attend these meetings. However, members of the BoS would have to be bound by the duty of confidentiality to gain access to confidential takeover-related information. Due to their role, employee representatives may have to disclose confidential information to some employees; these employees should also be required to comply with the duty of confidentiality. This rule is defined in the German laws,⁶⁴⁷ and can be adopted by the Chinese.

After setting up rules to provide information rights to the BoS, the next objective is to discuss ways to deepen this institution's participation in the takeover decision-making process. As explained in Section 5.1, in Germany, although the shareholder assembly has decisive power over takeover decisions, the decisions are largely shaped by

⁶⁴⁵ §90 of the *Stock Corporation Act* (2016) and Article 3.4 and Article 5.2 of the *German Corporate Governance Code* (2017).

⁶⁴⁶ N.F. Sharpe, "Volkswagen's Bad Decisions and Harmful Emissions: How Poor Process Corrupted Co-determination in Germany's Dual Board Structure" (2017) 7 *Michigan Business and Entrepreneurial Law Review* 49.

⁶⁴⁷ Article 3.5 of the *German Corporate Governance Code* (2017).

reasoned statements from the management and supervisory board members on the takeover offer, including the expected effects on the target company and employees should the takeover be successful.⁶⁴⁸ Meanwhile, in China, takeover decisions made by the shareholder assembly are influenced by the suggestions and opinions of the BoD and independent financial advisors;⁶⁴⁹ the laws do not mention the involvement of the BoS. Considering the consistently passive role of the BoS in corporate governance, its members would not be able to provide sound opinions on the takeover offer without a channel to provide them with sufficient and accurate information. These circumstances would change once the BoS has information rights and is required to be involved in the takeover decision-making process. They would then be able to issue statements about the consequences the target firm and employees should expect, providing the basis for shareholders to make informed decisions like their German counterparts. Accordingly, the BoS members' statement should be submitted to the CSRC along with other formal documents such as the statement of changes in equity, the statement of the BoD, and takeover reports.⁶⁵⁰

The BoD in Chinese firms exercise broad discretion over various matters that should be under the supervision of the BoS. As discussed in Section 2.2.3, this supervision could mitigate the opportunistic managerial behaviours of the BoD that may militate against the interests of shareholders and employees during takeovers. For example, similar to the German laws,⁶⁵¹ certain takeover defence measures, such as the sale of crown jewels or other valuables that may cause an undervaluation of the firm, are forbidden unless approved by the shareholder assembly.⁶⁵² However, other measures such as looking for a competing offer (referred to as "the White Knight") can be initiated by the BoD. To properly oversee the management board's behaviours, German laws require the consent of the supervisory board to be obtained before such measures are taken. The BoS in Chinese firms can also be endowed with similar rights to lower the risks of opportunistic managerial conduct, along with the right to gain information directly from the BoD as well as through the BoS members' participation

⁶⁴⁸ Section 27 of the *Securities Acquisition and Takeover Act* (2011).

⁶⁴⁹ Article 8 of *Takeover Measures*.

⁶⁵⁰ Article 87 of *Takeover Measures*.

⁶⁵¹ Section 33 of the *Securities Acquisition and Takeover Act* (2011).

⁶⁵² Article 33 of *Takeover Measures*.

in BoD meetings. Under the supervision and with the cooperation of the BoS, the BoD would be expected to take the employees' interests into account as it would be in the best interests of the firm.

To Improve the Effectiveness at the Individual Level

The deeper involvement of the BoS members in the takeover-related meetings would provide employee representatives with increased opportunities to express their opinions and suggestions. The next step to establishing the co-determination system at the board level would be to make these employee members better represent the workers' interests.

The German Corporate Governance Code suggests that employee and shareholder members hold separate meetings in preparation for the supervisory board meeting. If necessary, these preparatory meetings can also be held with members of the management board.⁶⁵³ This rule can also be implemented in Chinese firms, especially since it can help address certain board representation problems. It should be noted that the employees and shareholders' opinions on various matters may be different depending on whether the decision is in their interests. If their interests conflict, the employee members may be reluctant to express their dissenting opinions in front of the shareholder members and play a passive role in the meeting, as discussed in Section 5.2.1. If the different groups are offered opportunities to consider the interests of their respective constituencies in preparatory meetings, without any intervention from other members on the BoS, they are more likely to form opinions that favour employees. Evidence shows that involving every member and obtaining diverse opinions would positively affect the supervisory board's effectiveness.⁶⁵⁴ Although the members may have diverse opinions prior to the supervisory board meeting, introducing this rule would drive them towards finding a compromise in the best interests of the company. In addition, it would provide opportunities for the representatives of each board to raise

⁶⁵³ Article 3.6 of the German Corporate Governance Code (2017).

⁶⁵⁴ C. Kratz, A. Roos, U. Pidun and S. Stange, "Learning from the Best Supervisory Boards: Recipes for Success by Board Chairs of German DAX Companies" (2018) *The Boston Counselling Report*, available at <https://www.bcq.com/publications/2018/learning-best-supervisory-boards-success-chairs-german-dax-companies.aspx>.

their concerns to the management board before the BoS meeting.⁶⁵⁵ This facilitates cooperation between the BoS and BoD, and this increased communication is expected to reduce conflicts between the two boards.⁶⁵⁶ Further, opinions from the perspective of the employees' interests would be expressed to the BoD before a statement is made in the BoS meeting.

Another factor that hinders the BoS's role in safeguarding workers' interests is the composition of the board's employee members. Most of the employee representatives are from the executive team and can hardly represent employees at the establishment level. In contrast, the German laws include strict rules on the proportion of shop-floor employees required on the supervisory board. Without the involvement of workers at the establishment level, these members cannot properly represent the general employees. As analysed in a prior section, this improper board composition in China is partly due to the party-state's influence over the election process; this cannot be expected to change soon. The party-state is expected to retain its leadership over industrial relations due to China's unique political and economic system. However, with the solid support of the party-state, employee representatives would be able to participate in the takeover decision-making process more effectively, and the introduction of the employees' co-determination rights should, therefore, rely on the party-state's influence.

Based on the Chinese economic conditions, three possible directions have been identified to improve the participation of shop-floor employees, as per the objectives of this thesis. First, there should be legal requirements for the number of BoS representatives from employees at each level. For instance, there should be a minimal number of executive members and shop-floor employees respectively who are elected as employee representatives on the BoS. Second, in the context of takeovers, shop-floor employees should be invited to the BoS as temporary members. Third, as a part of their takeover-related responsibilities, members of the BoS should be encouraged to obtain suggestions from the employees at the establishment level. The first direction

⁶⁵⁵ Du Plessis (n 644).

⁶⁵⁶ L.L. Dallas, "Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson" (1997) 54 *Washington and Lee Law Review* 91.

provides the most direct solution for the Chinese problems. However, this change may lead to shop-floor employees' participation in corporate governance beyond corporate takeovers, which may be too ambitious at this stage. Therefore, the second direction has been suggested, enabling the shop-floor employees to contribute to the BoS meetings. However, two problems may arise, the first of which lies in the selection of the representative. If the temporary member is to be perceived as representing workers' interests in general, he/she should be elected by the Workers' Congress; but this may lead to practical difficulties. Workers are not required to be informed of a potential takeover before the publication of the offer due to factors of confidentiality.⁶⁵⁷ An election prior to the publication of the takeover offer may disclose confidential information about the takeover. An election after the publication of the offer is also impractical as the temporary member may be unable to be involved in the entire process of takeovers, especially considering that the election process takes time. The other problem is that the elected employee representatives may not have the necessary experience or knowledge of law and auditing to perform the role of a BoS member. Compared to the former two suggestions, the third is feasible since it can fit into China's current legal system. Instead of the shop-floor employees directly participating in meetings of the BoS, they would choose employee members on the BoS to represent them. As suggested by the ACFTU, employee members on the BoS should collect employees' thoughts on a routine basis.⁶⁵⁸ If this suggestion is voluntarily implemented, the employee members on the BoD should be clearly aware of workers' demands towards a potential takeover. The representatives should be required to consult with the shop-floor employees to understand the employees' attitudes towards the potential takeover; however, the consulted should be similarly bound by the duty of confidentiality. This consultation should constitute one of the bases for the BoS members' opinions and attached to their submitted statement.

Third, employee members should perform their responsibilities without any concerns. These concerns would generally lie in two aspects. First, since a large portion of the

⁶⁵⁷ In German takeovers, works council should be informed promptly after the publication of the takeover offer. See Section 10 of the *Securities Acquisition and Takeover Act* (2011). In takeovers in the UK, workers should be informed promptly after the commencement of offer period. See section 2.11 of the *City Code*.

⁶⁵⁸ ACFTU, *Opinions of the ACFTU on Further Promotion of the Systems of Employee Directors and Employee Supervisors* (中华全国总工会关于进一步推行职工董事职工监事制度的意见) (2006).

employee supervisors would hold concurrent positions in the firm, to prepare for and attend meetings of the BoS may mitigate their performance levels as executives of the firm. It should be noted that their German counterparts do not share similar concerns due to their significant roles in their companies. However, other rules that aim to safeguard the interests of the works council can be introduced. It would be prescribed that BoS meetings should be held outside working hours unless necessary; and that employees should be provided with hourly remuneration for meetings held outside working hours and not penalised due to meetings held during working hours.⁶⁵⁹ Second, to disagree with the opinions of the BoD members may expose them to risks of retaliation from the latter. Accordingly, any unfavourable treatment, such as job losses or wage cuts, resulting from employee members exercising their responsibilities should be prohibited.

6.2.3 Conclusion

In this chapter, arguments were presented for the introduction of a German-type co-determination mechanism at the board level of Chinese firms in the context of hostile takeovers. While employee representatives exist on both the BoD and the BoS in Chinese firms, the BoS was chosen as the ideal platform for introducing the employee representatives' co-determination rights in this thesis. Accordingly, two objectives were outlined to be achieved: improving the participation of the BoS in the takeover decision-making process and the effectiveness of employee representatives in safeguarding workers' interests.

Based on the German laws, several principles need to be identified to guide employee supervisors in exercising their responsibilities. First, although employee representatives are supposed to safeguard workers' interests, their responsibilities are to include workers' voices in takeover decisions for the best interests of the firm. Therefore, a compromise normally takes place during the meetings of the BoS. Second, as the supervisory organ, the role of the BoS is not to challenge the BoD but work cooperatively with it. Hence, BoS meetings should not be a conflict between the

⁶⁵⁹ Section 44 of *the Works Constitution Act* (2017).

employees and shareholders contesting for their respective interests but a friendly negotiation to explore the best possible decision for the firm.

Having provided some possible directions for the establishment of workers' co-determination rights at the board level, we explore the co-determination mechanism at the establishment level in the next section.

6.3 Employee Participation at the Establishment Level

In the German laws, the employee co-determination system's focus at the board level and the establishment level are slightly different. The former takes advantage of the workers' inputs to improve the quality of corporate decisions, with the intention of benefiting the firm, while the latter focuses on matters related to the employees' direct concerns. Since employees are vulnerable to negative treatments in takeover situations, they require information and participation rights which, in turn, benefit firm value. Chinese laws endow workers with these rights, but they cannot be effectively exercised. Meanwhile, German companies are renowned for their co-determination mechanism at the establishment level, the core organ of which is the works council. Therefore, an attempt to adapt the German system to Chinese firms with objectives to ensure workers' information and participation rights are upheld is made in this thesis.

6.3.1 Right to be Informed About the Takeover

As one of the most significant stakeholders of any firm, employees should be entitled to information about potential takeovers and the expected consequences for the firm and them. However, the provision of these rights requires careful prescription. On the one hand, employees should have sufficient time to effectively exercise their rights. On the other hand, they should not be informed too early as it may lead to a disclosure of confidential information. German laws provide an ideal way to satisfy these seemingly contradicting needs and can also be introduced to govern Chinese firms.

During takeovers, subject to the duty of confidentiality, the employer in Germany is expected to inform the finance committee that is affiliated to the works council about the situation and provide relevant documentation related to the takeover. In the absence of a finance committee, the works council should be informed instead. After prior coordination with the finance committee, the employer has to provide reports on the takeover and any further developments to the staff at least once every calendar quarter, promptly starting after the publication of the takeover.⁶⁶⁰ Following the publication of the takeover offer, the finance committee or works council also has the right to obtain the takeover documents, including the bidding documents and statements from the management and supervisory board, promptly after their publication.⁶⁶¹

During the early stage of a takeover, and particularly before the official publication of the offeror's intention to engage in takeover intention, the finance committee or works council is chosen under German laws as the bodies to gain information and documentation on behalf of the employees. This legal arrangement helps keep necessary information confidential during the takeover process due to three factors. First, the members are bound by the similar confidentiality duties as the supervisory board.⁶⁶² Second, although exposing more members, in addition to those on the boards, to takeover documentation may increase the risk of information disclosure, the number of members on both the finance committee and the works council is limited.⁶⁶³ This lowers the risk to a minimal level. Third, this rule does not specify the exact time of notification, leaving it up to the employer's discretion for the sake of confidentiality. However, the finance committee retains the right to challenge the employer if the latter does not hand over the information in a timely manner, as required by the laws.⁶⁶⁴

Meanwhile, the finance committee can well represent the employees' interests effectively, especially considering that it must include at least one member of the

⁶⁶⁰ Sections 106, 109, and 110 of *the Works Constitution Act* (2017) and Section 10 of *the Securities Acquisition and Takeover Act* (2011).

⁶⁶¹ Sections 14 and 27 of *the Securities Acquisition and Takeover Act* (2011).

⁶⁶² Article 3.5 of *the German Corporate Governance Code* (2017).

⁶⁶³ If the number of employees exceeds 100, a finance committee is required, with members between 3 and 7. If the number of employees is fewer than 100, the maximum number of members of the works council is 3. See Section 9 and 107 of *the Securities Acquisition and Takeover Act* (2011).

⁶⁶⁴ Section 109 of *the Works Constitution Act* (2011).

works council.⁶⁶⁵ It has extensive rights to consult with the employer on takeover-related matters whilst being obliged to report to the works council, the workers' representation organ at the establishment level. In addition, the takeover information reported by the employer to the staff should be subsequent to the prior coordination with the finance committee.⁶⁶⁶ The participation of the finance committee tends to facilitate the provision of an accurate, full, and timely report to the employees.

The German mechanism provides a sound model for Chinese firms to uphold employees' information rights during takeovers. However, it is noted that the structure of the worker representation mechanism in China is different from that in Germany. Therefore, it is necessary to identify the ideal institution to perform the role of the finance committee or works council in Chinese firms before they adopt this system. The identified institution should have two characteristics: First, it should be able to represent workers' interests; second, the number of members should be limited. Accordingly, the Workers' Congress should be excluded, since it has no fewer than 30 members to represent the broad interests of the employees.⁶⁶⁷ Instead, the Chinese trade union committee is chosen as the counterpart of the German finance committee for the purpose of this thesis.

The trade union committee is affiliated to the trade union, which is the executive organ of the Workers' Congress.⁶⁶⁸ It is obliged to arrange the meetings of the Workers' Congress and supervise the management on implementing the decisions made in these meetings,⁶⁶⁹ and, therefore, it is deemed to represent employees' interests in Chinese firms. These responsibilities require the trade union committee to frequently communicate with the management on behalf of the employees, which is similar to the finance committee in German firms. Further, its members are similarly limited and required to include a certain portion of shop-floor employees.⁶⁷⁰ The high degree of

⁶⁶⁵ Section 107 of *the Works Constitution Act* (2011).

⁶⁶⁶ Section 110 of *the Works Constitution Act* (2011).

⁶⁶⁷ Article 38 of *Democratic Management Provisions*.

⁶⁶⁸ Article 35 of *the Trade Union Law of PRC*.

⁶⁶⁹ Article 6 of *the Trade Union Law of PRC*.

⁶⁷⁰ Article 8,9 and 10 of *Regulation of the Election of the Trade Union at the Establishment Level* (《工会基层组织选举工作条例》) (2016).

similarity makes the trade union the ideal organ to function in a role similar to the finance committee. However, this would be a hasty conclusion to reach before several issues are addressed.

First, in theory, the trade union is independent, which means that it is not under the domination or control of any employer. Therefore, as the committee affiliated to the trade union, whether its access to confidential information at the early stage of takeovers is justified is doubtful. However, in Chinese firms, the trade union is inclined towards being dependent on the firm due to historical reasons. As examined in Chapter 3, enterprises in the old planned economy were under an administrative hierarchy and had to carry out production missions assigned by the party-state.⁶⁷¹ Therefore, these old enterprises were indispensable to the party-state, and the trade unions under the leadership of the party-state were also internal to the enterprises. Accordingly, instead of safeguarding workers' interests, the objectives of the trade union were to help the party-state improve the production levels of the enterprise by relieving the workers' concerns and educating them to better implement the policy of the party-state.⁶⁷² After the introduction of the modern corporate system, the party-state was no longer the controller and was gradually excluded from the corporate governance system of private firms, but the trade unions remained internal to the modern firm. For instance, the leaders of a trade union normally hold concurrent positions in the management and the CPC committee of the firm,⁶⁷³ making them inseparable from the firm. Hence, unlike those in western countries, the trade unions in Chinese firms are internal rather than independent organs. This thesis does not include a justification of the trade unions' lack of independence and their corresponding ineffectiveness in safeguarding workers' interests. Instead, the objective of this thesis is to identify the role of the trade union in Chinese firms in practice, which is path dependent and cannot be changed in the expected future. Therefore, the trade union's access to confidential information at the early stage of takeovers can be justified due to its close connection with the employer.

⁶⁷¹ A.G. Walder, *Communist Neo-Traditionalism: Work and Authority in Chinese Industry* (University of California Press-1986) 86.

⁶⁷² Zhang and Xu (n 617).

⁶⁷³ Liu and Zhang (n 344) at 19.

Second, it should be noted that the works councils in German companies are expected to cooperate with the employer towards the interests of the employees and company. Considering the priority of trade unions is to safeguard the workers' interests,⁶⁷⁴ whether they can similarly cooperate with the employer for firm value is doubtful. Since trade unions can be perceived as internal organs in Chinese firms and the trade unions are dependent on the firms, cooperation between trade unions and the employers is widely found in China. According to an interview with the chairman of a trade union in a private firm,⁶⁷⁵ by realising the alignment of the workers' interests with those of the firm, the function of the trade union is to encourage and help workers implement the decisions made by the employer in addition to safeguarding the workers' interests. As an organ internal to the firm, a trade union tends to cooperate with the management to safeguard workers' interests instead of fighting against it, especially considering that they do not have the right to strike.⁶⁷⁶ Accordingly, the role of trade unions in Chinese companies is similar to that of the works councils in German firms, and therefore its affiliated organ, the trade union committee, can function the similar way that finance committee does.

Having identified the organ through which access to information and documentation at the early stage of takeovers can be gained, the mechanism to inform workers of potential takeovers can now be established. Before the publication of the takeover, the BoD should inform the trade union committee of the forthcoming takeover, provide relevant documentation, insofar there is no risk of disclosing the trade or business secrets of the company, and demonstrate the implications of the proposed takeovers for the workers. Promptly after the publication of the offeror's intention to take over the firm, the trade union committee should be informed of the process of the proposed takeover timely. Documentation such as the bidding documents and statements of the BoD and BoS on the takeovers should also be offered to the trade union committee.

⁶⁷⁴ Article 6 of the *Trade Union Law of PRC*.

⁶⁷⁵ G. Feng, "The Systemic Weakness of Trade Unions in Enterprises and Its Background" (企业工会的制度性弱势及其形成背景) (2006) 26 *Society* (社会) 1.

⁶⁷⁶ M. Su, H. Yao and L. Zheng, "The Legal Confirmation and Regulation of the Right to Strike" (法律对罢工权的确认及规范) (2001) 5 *Legal Science* (法学) 12.

After prior coordination with the committee, the BoD should report relevant details to the Workers' Congress in preparation for the consultation.

Due to the heavy dependence of the trade union on the firm, a concern arises as to whether the trade union committee members have enough of an incentive to exercise their obligations. The fact that trade unions in private firms are under the control of the party-state, which is powerful but unpredictable, adds to this concern. Therefore, explicit rules should be provided to regulate the committee's conduct and hold them accountable. For instance, the report should be provided to the staff within a specified period after the publication of the takeover offer. In addition, employees should be given the right to challenge members of the trade union committee if they shirk their responsibilities during takeovers. Some possible directions for the rules are given in this thesis; the details would have to be refined in the future. Possible channels to enable Chinese shop-floor employees' participation in takeover decisions are explored in the next section.

6.3.2 Right to Participate in Takeover Decision-Making

From the perspective of the employees, issues arising from the forthcoming takeover can be divided into two categories: takeover decisions that relate to the interests of the firm; and issues of direct concern to the shop-floor employees, especially with regard to how they will be treated in the restructured firm after the takeover. Workers are expected to have different levels of participation rights depending on the category the relevant issues fall under, and this is reflected in the German laws.

Collecting employees' opinions on the potential takeover is not a compulsory procedure in the German laws. Instead, if the works council members or employees (in the absence of a competent works council) of the target firm submit their reasoned statement commenting on the takeover offer to the management board, the management board must append this statement to its own as a vital basis for shareholders to make informed decisions. This legal arrangement facilitates the direct transmission of employees' views to the shareholders who retain the decisive power

over takeover decisions. In addition to the statement of the supervisory board on the offer, this provides a channel for shop-floor employees' views to be included in the takeover decisions. As a result, although the management board is not required to ask the works council for advice on takeovers, the workers are able to make their opinions heard under the German laws.

In comparison, although the laws require the management in Chinese firms to consult with the workers on the forthcoming takeover, they are not obliged to convey the workers' opinions to the shareholders, making these procedural requirements a mere formality. Although the managerial team are expected to make more informed decisions and suggestions to shareholders by considering the workers' opinions on the takeover. However, the workers' views need to be heard by the shareholder assembly in order to make informed takeover decisions. The workers' involvement can be enabled by introducing rules similar to the German system. A well-reasoned statement by the workers, commenting on the takeover, can similarly be appended to the statement of the BoD, which is required by the CSRC and deemed to be the basis for the shareholders' decision-making process. However, since Chinese firms do not have works councils, it is necessary to explore how this statement can be made. Following the directions provided in Section 5.2.1, the trade union committee should be the organ that issues the statement on behalf of the employees. However, due to concerns about the effectiveness of the committee in safeguarding the workers' interests, the statement should be required to reflect the workers' opinions. Accordingly, these opinions should be collected during meetings of the Workers' Congress, which are organised by the trade union committee to provide information about the takeover to the employees.

German law does not include any rules regarding issues of direct concern to workers, specifically in the context of takeovers. However, as summarised in Section 5.1, works councils have co-determination rights covering a broad range of issues touching on the treatment of workers, such as job cuts, job transfers, and changes in working hours. Therefore, the new employer should be mindful of industrial relations while restructuring the firm after the takeover.

It should be noted that while Chinese workers do not enjoy a similar level of protection, introducing the co-determination rights of works councils as a matter of general practice to Chinese firms is not realistic as it would require a systemic change in the Chinese corporate structure. However, this thesis argues that workers should be endowed with co-determination rights for takeover scenarios only and that this is a feasible package of reform. Since it would not be appropriate to directly introduce the German system, the rules for the workers' co-determination rights can be found in China's own legal system. To be specific, the Workers' Congress should have rights to deliberate upon and approve plans for the treatment of employees in takeover situations, including the new employer's detailed plan on issues such as job cuts, job transfers, and their corresponding compensations.

This plan arises from the context of the SOE reforms, by which workers with "guaranteed lifetime employment in state enterprises"⁶⁷⁷ were changed to employees by contract. In the old planned economy, workers in state enterprises were provided with various employment-related benefits, such as pensions and healthcare allowances, to cover their needs "from cradle to grave".⁶⁷⁸ During the SOE reform, workers were confronted with a substantial reduction in welfare benefits and a huge number of workers were laid off, which intensified the workers' conflicts with the party-state. Therefore, to alleviate these conflicts during the transition period, the worker treatment plan was suggested, especially in private investors' takeovers of SOEs.⁶⁷⁹ This plan is generally divided into two parts. The first part includes details of the workers who will be laid off, whose job positions will change, or who are awaiting reassignment within the enterprise, while the second part is mainly about how workers are compensated and the measures that are undertaken to help lay-offs find re-employment. Similarly, in takeovers of private firms, workers are vulnerable to unfair treatment. As analysed in Chapter 2, safeguarding workers' interests has a positive effect on the productivity rate and, accordingly, the firm's value. Therefore, workers in private firms should be given similar co-determination rights as their counterparts in SOEs. It should be noted that this rule can fit well into the current legal system in China. For instance, while

⁶⁷⁷ BBC News (n 316).

⁶⁷⁸ C.J. Finan, *Social Policy Reform in China: Views from Home and Abroad* (Routledge-2003) 1

⁶⁷⁹ Article 14 of *Democratic Management Provisions*.

formulating or amending rules or making decisions on issues directly related to the interests of employees, employers are currently under a legal duty to discuss these issues with employees in meetings of the Workers' Congress on an equal basis.⁶⁸⁰ This rule lays the procedural foundation for the new employer to negotiate the plan for employee treatment in takeover situations, especially considering this plan can be interpreted as covering issues of direct concern to the workers. In addition, a change in the investors does not affect the fulfilment of the employment contracts. This helps incumbent employees to proceed through the transition period until the completion of the takeover, in preparation for meetings of the Workers' Congress to negotiate the employee treatment rules while restructuring of the firm. On the condition that a plan is agreed to by the new employer and the Workers' Congress, as suggested in this thesis, the management of the acquired company should be required to report a series of issues, including the treatment of the employees, on a quarterly basis within one year after the completion of takeover. This rule can be used to persuade the new employer to implement this approved plan.⁶⁸¹

6.3.3 Conclusion

This section provided an overview of channels through which workers' can be informed of forthcoming takeovers and participate in the takeover decision-making process at the establishment level. This mechanism is suggested by drawing lessons from the German co-determination mechanism, which is adapted into Chinese current legal system.

The trade union committee would be the core institution in the suggested scheme because of four factors. First, it is entitled to information and documentation at the early stage of a potential takeover, on the behalf of the workers. Second, this institution can arrange meetings of the Workers' Congress for shop-floor workers to gain information, express their views on the takeover, and deliberate upon and approve the plan for the future treatment of employees. Third, the committee is responsible for

⁶⁸⁰ Article 4 of *the Labour Contract Law of PRC*.

⁶⁸¹ Article 72 of *Takeover Measures*.

collecting workers' views on the takeover and issuing the workers' statement, which should be appended to that of the BoD. Fourth, as the institution committed to representing workers' interests and towards working in the firm's best interests, it is expected that this structure would alleviate any conflicts that emerge between employers and the employees.

Therefore, the trade union committee plays a crucial role in protecting workers' information and participation rights and should be supervised by the party-state; i.e. the trade union and relevant government bodies such as the departments of human resources and social security at the upper level. To improve its effectiveness, trade union members and employees should be required to report any violation of the trade union's obligations to these supervisory bodies.

6.4 The Feasibility of the Suggested Mechanism

Based on the theory of legal transplantation, the introduced German mechanism is likely to not be feasible in the Chinese context. Accordingly, this section examines the level of feasibility of the suggested mechanism in the Chinese context. In general, there are six obstacles working against the German system being adapted to the Chinese corporate structure in hostile takeovers. Three of them can be addressed by the modifications to the German scheme. On the other hand, resistance still exists, based on the economic and cultural considerations.

6.4.1 Three Major Challenges that Can Be Addressed

The first is the difference between organisational structures at the board and establishment levels. It is difficult to find institutions in Chinese firms that can be expected to function the same way as their German counterparts. There are two possible solutions to overcome this challenge, the first of which is to introduce the entire German structure of corporate governance into Chinese firms. This solution is too ambitious at this stage, especially considering the historic background of the Chinese corporate governance system and the party-state's leadership. In addition, it

goes way beyond the scope of this research project. Accordingly, a second and comparatively advisable solution is to provide workers with co-determination rights without a dramatic change in the role and function of the institutions currently present in Chinese firms.

The second challenge arises from an analysis of the selected institution that would be able to perform the required functions. At the board level, the BoS is considered as the counterpart of the German supervisory board, but its role during takeovers has not been specified in Chinese laws. Therefore, directions are provided in this thesis to define the role of the BoS and improve workers' involvement in the takeover decision-making process. At the establishment level, the trade union committee has been chosen as the counterpart of the finance committee or works council in the German system for the purpose of this thesis. Unlike those in western countries, trade unions in Chinese firms are internal to the firms, albeit with the external support of the party-state. Since it endeavours to work towards the interests of the firm, which is similar to the role of the works council in Germany, this thesis argues that the trade union committee would be the appropriate organ for the exercise of the responsibilities of the works council.

The third challenge comes from the systemic deficits in the Chinese firms' worker treatment methods. Throughout Chinese history, the extent to which workers have been involved in corporate decisions has depended on the needs of the party-state. Therefore, the party-state can either be the powerful driving force behind adapting the German system in China or the resistant force behind the introduction of this system. However, as argued in Chapter 5, the introduction of German co-determination is compatible with the party-state's needs for economic development and a more innovative economy. Therefore, it is submitted that the party-state would indeed be willing to adopt and promote the enforcement of the suggested mechanism because it would realise that this mechanism would align with the party-state's interests. Detailed rules would need to be provided to restrict the party-state's discretionary behaviours on the part of the party-state while it enforces this system.

6.4.2 Possible Resistance from Chinese Environment

By overcoming these challenges, the German codetermination mechanism can be adapted to the Chinese corporate structure. However, enforcing this scheme may cause two major concerns to arise.

This first is the negative impact of the labour co-determination mechanism on the takeover process. Workers' deeper involvement in takeover decisions may lower the attractiveness of target firms from the perspective of corporate raiders and raise the difficulty of finalising a takeover due to the workers' resistance to the takeover. This is a plausible concern, especially considering that hostile takeovers are rare in Germany.⁶⁸² However, the difficulty in executing hostile takeovers in Germany principally arises from the existence of cross-shareholdings and the two-tier board structure, which make it difficult for an acquirer to effectively exert any control.⁶⁸³ It should be noted that these circumstances are not observed in China since the cross-shareholding structure remains at an early stage of development and the boards are less powerful than their German counterparts. As such, the same obstacles to a hostile takeover that are encountered in Germany do not exist in China. Even in Germany, hostile takeovers have been more frequently observed in recent years.⁶⁸⁴ Accordingly, the introduction of the German co-determination system is not expected to slow down the rising trend of hostile takeovers in China. Additionally, the positive economic impacts of employee involvement in the hostile takeover process would also compensate for any issues that may arise. As analysed in Chapter 2, a moderate degree of co-decision making with workers would positively affect a firm's performance. In the context of takeovers, employee engagement is expected to develop positive beliefs

⁶⁸² "2016 Mergers and Acquisitions Reports: Germany" (2016) *International Financial Law Review*, available at <https://www.iflr.com/Article/3540080/2016-Mergers-and-Acquisitions-Report-Germany.html?ArticleId=3540080>.

⁶⁸³ J. Koke, "The Market for Corporate Control in Germany: Causes and Consequences of Changes in Ultimate Share Ownership" (2000) *Centre for European Economic Research (ZEW)*, available at https://www.cass.city.ac.uk/_data/assets/pdf_file/0003/65622/CPW1.pdf.

⁶⁸⁴ F. Mager and M. Meyer-Fackler, "Mergers and Acquisitions in Germany: 1981-2010" (2017) 34 *Global Finance Journal* 32.

and attitudes,⁶⁸⁵ which, in turn, is expected to increase shareholder returns, particularly in terms of monetary benefits.⁶⁸⁶

The second concern is whether the suggested Chinese mechanism can function in a similar way to its German counterpart. The steps involved in the enforcement of the co-determination system may be different from the German mechanism due to the prevalence of *guanxi* relationships and the paternalistic style of leadership in corporate governance. The *guanxi* relationships would be complementary to the legally mandated process as the employee involvement mechanism would provide a platform for the employee representatives, managers, and shareholders to develop sound interpersonal relationships. Since it is based on mutual trust and benefits, workers' compliance with firm regulations and policies as well as their managers' orders would enable managers to safeguard the employees' interests during the takeover decision-making process. Due to the paternalistic leadership style prevalent in China, developing a channel for workers' communication with members on the BoD would facilitate a change in the leadership style, from being authoritarian to being benevolent or moral, which would positively affect the employees' performance. As identified by scholars, there are three dimensions to a paternalistic leadership style: authoritarianism, benevolence, and morality. These three dimensions are defined as follows:⁶⁸⁷

Authoritarianism refers to leadership behaviours that assert authority and control and demand unquestioning obedience from subordinates. Under authoritarian leadership, subordinates comply and abide by leaders' requests without dissent. Benevolence refers to leadership behaviours that demonstrate individualized, holistic concern for subordinates' personal and family well-being. In return, subordinates feel grateful and obliged to repay when the situation allows. The third dimension, morality, depicts leader behaviours that demonstrate superior personal virtues (e.g., does not abuse authority for

⁶⁸⁵ A.M. Konard, "Engaging Employees through High-Involvement Work Practices" (2006) 70 *Ivey Business Journal* 1.

⁶⁸⁶ H. Liang, L. Renneboog and C. Vansteenkiste, "Corporate Employee-Engagement and Merger Outcomes" (2017) *CentER Discussion Paper Series No. 2017-011*, available at https://ink.library.smu.edu.sg/cgi/viewcontent.cgi?article=6236&context=lkcsb_research.

⁶⁸⁷ E.K. Pellegrini and T.A. Scandura, "Paternalistic Leadership: A Review and Agenda for Future Research" (2008) 34 *Journal of Management* 566.

personal gain, acts as an exemplar in personal and work conduct), which lead subordinates to respect and identify with the leader.

Chinese managers are believed to follow an authoritarian leadership style.⁶⁸⁸ The co-determination mechanism, which would allow workers to express their views to the BoD members, would enable the latter to tackle these concerns on behalf of their subordinates, facilitating a shift from authoritarianism to benevolence. In addition, frequent communications between the employee representatives and BoD members would perform a supervisory function, ensuring that the superiors behave themselves and act as role models for workers. This would facilitate a shift towards a morality-based leadership style. Empirical studies have showed that these changes positively affect workers' performance.⁶⁸⁹

The third concern arises from the enforcement mechanism: do employees have legal remedies if their involvement rights in the context of hostile takeovers are violated? In Germany, the works council is the key organ to safeguard worker participation rights. Specifically, if employee representatives are not elected legally or workers are treated unfairly after the completion of a takeover, the workers' council have the right to bring lawsuits on behalf of workers. However, Chinese firms do not have similar organ with the capacity to commence lawsuits on behalf of workers. Instead, workers can only refer to legal remedies individually if experiencing adverse treatments during the process of takeovers.⁶⁹⁰ Considering the imbalance of powers between the employer and the individual employee and the prevalence of paternalistic leadership style in Chinese firms, the Chinese workers need a counterpart of the German works council to collect workers' claims and sue in the court of law. To begin with, the Workers' Congress cannot be endowed with this right because the Workers' Congress is perceived as an internal institution of the company and, thus, does not have the independent role to initiate a lawsuit.⁶⁹¹ Therefore, the trade union is the only proper

⁶⁸⁸ M.W. Peng, Y. Lu, O. Shenkar and D.Y.L. Wang, "Treasures in the China House: A Review of Management and Organizational Research on Greater China" (2001) 52 *Journal of Business Research* 95.

⁶⁸⁹ X.P. Chen, M.B. Eberly, T.J. Chiang, J. Farh, and B. Cheng, "Affective Trust in Chinese Leaders: Linking Paternalistic Leadership to Employee Performance" (2014) 40 *Journal of Management* 796.

⁶⁹⁰ Article 77 of the *Labour Contract Law of PRC*.

⁶⁹¹ Article 48 of the *Civil Procedure Law of the People's Republic of China* (《中华人民共和国民事诉讼法》) (2017).

organ to bring lawsuits on behalf of workers. In theory, it has the right to take legal actions for the benefit of workers, but the scope of this right is limited. A lawsuit can only be raised when the trade union finds that there is a violation of collective employment contracts.⁶⁹² This is reasonable as the trade union is responsible for negotiating terms and conditions of the collective employment contracts.⁶⁹³ Based on the same ideology, if the trade union is given the responsibility to safeguard employee involvement rights in the context of hostile takeover, as suggested in this chapter, it is reasonable to endow the trade union with the right to take legal actions. However, as examined in section 3.3, the trade union itself has certain systemic deficiencies in safeguarding worker interests. In this regard, if worker involvement rights are infringed on by the trade union, no effective channel for employees seek remedies will be available. A possible solution is to establish the channel for the government, such as HRSS, to be involved in resolving these disputes. In fact, the government has traditionally acted as the mediator in the conflict between the employer and employees.⁶⁹⁴ The mediation role of the government arises from the context of grand mediation, which refers to the dispute resolution that “relies on mediation but links various social and governmental resources together aiming at resolving conflict more effectively”.⁶⁹⁵ It is perceived as complementary to the instable judicial system and inadequate legal remedies for workers. However, different from legal actions characterised by transparency, predictability, and certainty, the administrative involvement in conflicts between an employer and employees is under the discretion of the government. Therefore, whether the grand mediation can effectively safeguard employee involvement rights should be further examined in practice.

6.4.3 Conclusion

This section examines the whether the German co-determination mechanism can be acceptable to Chinese firms in the context of hostile takeovers. In general, although

⁶⁹² Article 20 of the *Trade Union Law of PRC*.

⁶⁹³ Article 6 of the *Labour Contract Law of PRC*.

⁶⁹⁴ L. Bu, “Details of Collective Bargaining in Nanhai Honda” (南海本田集体谈判始末) (2010) 9 *China Worker* (中国工人) 4.

⁶⁹⁵ J. Hu, “Grand Mediation in China” (2011) 51 *Asian Survey* 1065.

the corporate structure and economic system of Chinese firms are different from those of German ones, the German employee participation mechanism does not conflict with the Chinese context. However, due to the divergence of backgrounds between China and Germany, there are admittedly certain obstacles for the co-determination mechanism to be adapted to the Chinese context. The problems caused by differences in corporate structures can be addressed by certain adjustments of role and functions of the Chinese corporate organs. In addition, the party-state retains its say over the extent to which employees are safeguarded in the context of hostile takeovers. Meanwhile, there are certain factors that may lead to the infeasibility of the suggested system in Chinese firms, which includes the firm's economic considerations, the paternalistic leadership style, and a lack of enforcement mechanism. These problems can hardly be resolved immediately after the introduction of the suggested system. However, with further implementation of the co-determination scheme in the Chinese style, employers are expected to become aware of the positive impacts of the promotion of workers' interests on firm value and firm management then tends to communicate more with employees. For the enforcement system, the trade union should be given the power to bring lawsuits to the court and government mediation can be deemed as a complementary to this type of legal remedy. Its effectiveness needs to be further examined after the implementation of the suggested system.

Conclusion

1. Overview of Research Findings

The thesis has suggested adapting the German co-determination scheme to the context of Chinese firms, to improve workers' involvement in hostile takeovers. Based on the research questions detailed in the introductory chapter, the thesis is divided into three parts:

Part I

The first part, which includes Chapters 1 and 2, answers the question, "Why should employees' opinions be valued in the context of hostile takeovers?" Through use of a theoretical analysis, the thesis suggests that workers are vulnerable to a variety of adverse treatments, particularly in this context. This vulnerability arises in particular from post-takeover operational restructuring by new management. One explanation of this restructuring involves the market for corporate control, whereby corporate raiders tend to acquire underperforming firms and improve their performance levels following completion of takeovers. One of the most effective ways to do this is to cut labour costs; by definition, this includes measures such as mass redundancies, job cuts, and job transfers. The mindset of the new management, in leaving employees in an inferior position, arises out of the ideology of shareholder primacy, which prioritises shareholders' interests at the expense of those of other stakeholders. It should be noted that such adverse treatments of workers are less likely to emerge if the nature of the takeover is not hostile. In such a scenario, employees are perceived to have an implicit contract with the employer, expressive of a willingness in both parties to establish a long-term and stable employment relationship. The implicit employment contract, which aims to encourage workers' specific investments, is sustained by the workers' trust in the management. Accordingly, management turnover after takeovers breaks the workers' implicit connections with their employer, which are fundamental in helping maintain their employment stability.

The other finding that supports a deeper involvement on the part of the worker is that the company also needs employee participation in the event of hostile takeovers, since this is positively correlated with firm value. Through its examination of empirical studies, the thesis finds that a moderate level of employee involvement positively affects job satisfaction amongst workers, job commitment, and, in turn, worker productivity and firm value. This positive correlation can be illustrated by two theories. First, due to the incompleteness of the contract between employer and employees, the extent to which both parties make relationship-specific investments cannot be contracted. Accordingly, in the context of hostile takeovers, in which they are confronted with unpredictability and uncertainty, workers tend to withhold their firm-specific investments, in order to avoid being held up by their employer. Informing employees of the potential takeover and establishing channels by which they can express their opinions, alleviates this inclination amongst workers to withhold their investments in the employment contract. Second, inspired by agency theory, the relationship between employer and employees constitutes an agency relationship. The employee's involvement mechanism plays a monitoring role in curtailing managerial behaviours that infringe on workers' interests. This mechanism is also compatible with shareholders' interests. By recognising the employee advantage of owning 'inside information' regarding how the company is managed, workers' voices, in being heard by shareholders, can curtail managerial rent-seeking behaviours which are known to jeopardise shareholder interests. It should be noted that taking employees' interests into consideration is not supported by the corporate governance ideology of shareholder primacy. However, some comparatively stakeholder-oriented models, such as enlightened shareholder value, team production theory, and stakeholder theory, provide a theoretical basis for workers' deeper involvement in hostile takeovers.

Part II

This part, which mainly comprises Chapter 3, addresses the research question, "What are the reasons for the problems in employee protection in the context of hostile takeovers in China?" This part begins by using the theoretical analysis to examine the

ideology of corporate governance in Chinese firms. It suggests that Chinese firms have adopted the model of shareholder primacy, which prioritises the interests of shareholders, to the exclusion of others. At the institutional level, the doctrinal methodology is employed, to illustrate that worker representation mechanisms, as operational in trade unions and the Workers' Congress internal to the firm, are far from effective. The most obvious reason for this is that Chinese law does not provide details on how this mechanism can be operated effectively. However, the core reason is that this mechanism is under the control of the party; thus, the extent to which workers' interests are accommodated depends on party-state policy. Through employing path dependence theory to examine the history of this mechanism, the thesis finds that this mechanism was embedded in the old planned economy, which is incompatible with modern corporate structures. Therefore, in order to make the worker representation mechanism operational in an effective way, certain modifications are necessary; these are addressed in Part III.

Part III

This part, which includes Chapters 4, 5, and 6, is in response to the third research question, "How can the issues of labour protection be addressed in the context of hostile takeovers in China?" By using the methodology of a comparative study, this section suggests the resolving of the Chinese problem by transplanting the German co-determination scheme into Chinese firms in the context of hostile takeovers. This approach is referred to as that of "legal transplants". Due to the divergence between the domestic environments of China and Germany, whether it is possible to adapt the German mechanism to the Chinese context remains the major concern. This thesis, therefore, takes three steps to address the issue of the prudent transplantation of the German scheme.

The first of these steps involves the justification of the introduction of the German co-determination scheme. This thesis firstly provides three explanations for this choice. The first, and most obvious, of these is that German firms are renowned for their co-determination mechanism, which endows employees with strong and effective

participation rights. Thus, it is equipped to effectively address the problem in Chinese firms. The second and third explanations are derived from using the VoC approach. The Chinese economy has a high level of similarity with the German economy in terms of methods of coordination between firms. However, Chinese firms follow a different approach to the treatment of workers, leading to institutional incoherence. This is incompatible with the demands of the Chinese economy for development and innovation. Given the similarities between the two economies, it would be institutionally coherent for the German co-determination mechanism to be readily operational in the context of the Chinese economy. Further, since it would benefit the economy, it would align with the interests of the party-state – the driving force behind such a transplant.

The second of the steps is to identify the differences in organisational structures and ideologies underlying the worker representation mechanism, which are perceived as obstacles to transplantation. This thesis suggests that the differences lie at both the board level and the establishment level. With respect to employee representation at the board level, the BoS of Chinese firms are functionally similar to the supervisory boards of German firms. However, the former has comparatively limited power. At the establishment level, the Workers' Congress in China can be deemed to be the counterpart of the works council in Germany. However, Chinese shop-floor workers do not have the co-decision rights that German workers do. This can be attributed to the different ideologies underlying the arrangements. While German firms value the spirit of democracy, mutuality, and equality, Chinese firms uphold a paternalistic leadership style, which requires subordinates to obey their leaders. In addition, given the dominance of the party-state over industrial relations, it is almost impossible to expect Chinese firms to voluntarily adopt the employee involvement mechanism.

By recognising the differences between the two systems, this thesis suggests possible amendments in the effort to adapt the German system to the Chinese context. It should be noted that the supervisory board and works council are the key institutions that facilitate employee participation in takeover decision-making in Germany. In China, their counterparts are the BoS and the trade union committee, respectively. At the

board level, the BoS is required to play an active and crucial role in the takeover decision-making process. Since it is required that at least a third of the BoS consists of employee members, there is a channel for including workers' opinions on takeover decisions. At the establishment level, it is expected that the opinions of shop-floor employees are valued. Their reasoned statements on the forthcoming takeover should be transferred to the shareholder assembly, the decisive organ during the takeover process. Issues of direct concern to employees, such as the new employer's plans for job cuts, job transfers, or wage changes, should be approved by the workers through meetings of the Workers' Congress. In light of the differences between the cultural and political contexts of Germany and China, Chinese firms are likely to display a pattern of worker-management coordination during the takeover decision-making process that differs from the pattern observed in German firms. However, the suggested mechanism could serve to improve workers' involvement in hostile takeover decisions in China, to the benefit of employees, shareholders, and the firm as a whole.

2. Contributions to Legal Scholarship

The first contribution of this thesis is to draw attention to the employees' claims in the context of hostile takeovers in China, which attracts few attentions from legal scholarship. As examined in section 1.3, hostile takeovers are referred to as the market for corporate control, which is the mechanism to discipline underperformed management. In this case, literatures on hostile takeovers mainly focuses on the relationship of incumbent shareholders and management of the target firm. In addition, as mentioned in section 1.1, hostile takeovers are perceived as the battlefield of incumbent management of target firm and corporate raiders, and therefore regulations on takeover defence tactics attract broad scholarship attention.⁶⁹⁶ However, as one of the most significant constituents of the firm, employees have significant stakes in the hostile takeover and its proceeding managerial turnover. Therefore, the thesis pays attention to employees in this context. By examining the workers' vulnerability to adverse treatments and the positive impacts of workers' involvement in the process of

⁶⁹⁶ See Armour et al (n 24) and Armour and Skeel (n 25).

takeovers, the thesis highlights the significance of employees' claims in the context of hostile takeovers.

The second contribution is to put labour protection problems in China in the broader landscape of corporate governance. In doing so, this research is expected to provide a fresh perspective on the examination of problems relating to stakeholders and employees in the Chinese firms in particular as well as how they ought to be addressed. According to the incomplete contract theory, which is introduced in introductory paragraph of Chapter 2, in addition to the contractual connection, due to workers' human capital in the firm, they should be deemed as residual claimants, similar with shareholders. This makes workers' interests closely connect with those of the firm, which is beyond the mere employment relationship. Therefore, employees, as the stakeholder of the company, should play a role in major decision-making (including decisions in hostile takeovers), since their interests connect closely with the firm. In this regard, the thesis examines the major corporate governance models to provide theoretical foundation for workers' involvement in corporate in section 2.1. Before to introduce the German mechanism to Chinese firms, its underlying ideology is examined, in order to clarify the extent to which employees should be involved in hostile takeovers.

The third contribution is to examine firm's treatments on workers from the macroeconomic perspective, which is mainly presented in Chapter 4. Although the approach of varieties of capitalism has highlighted the importance of firms' ways of coordination with workers in national economies and their capability to innovate, few researches ever attempt to explore the employee protection problem in this broad context. However, in the context of China, the party-state has strong demands for economic development and innovation. Hence if the workers' deeper involvement in hostile takeovers cannot meet these demands, it cannot be feasible in China, considering that the party-state is the major driving force of law-making. By comparing the economic systems between China and Germany, the thesis originally identifies the institutional incoherence of the Chinese economic system, and further

argue that the introduction of the German ways of treatments on workers can meet with the party-state needs for innovation and economic development.

The fourth contribution is to use the approach of “legal transplants” to resolve Chinese legal problems. It is admitted that China has a long history of legal transplantation, but considering the unique historical, cultural, political, and economic backgrounds of China, the importing of western rules is a challenge. The use of legal transplantation is controversial in scholarship. This is because as stated in Section 3.5, the law is embedded in its unique domestic environment, and therefore legal transplantation tends to become a challenge if there is a significant divergence from the origin of rules. In order to address this resistance, this thesis sets out three principles for using legal transplants. First, the imported rules should be able to effectively solve problems in importing country. This thesis argues that the introduction of the German co-determination mechanism to Chinese firms can effectively improve workers’ participation in decision making during the takeover process, which complies with this first principle. Second, the foreign rules should be attractive to the dominant force in the host country. As identified in Chapters 3 and 4, the party-state has a dominant role in the economy as well as in legislation. By arguing that German co-determination is coherent with China’s demands for economic development and innovation, the introduction of the German system is not expected to be resisted by the party-state. Third, the transplanted rules should be feasible in the local context. Accordingly, this thesis attempts to establish a Chinese worker representation system in takeover decision making based on the current institutional framework of Chinese firms. In addition, this thesis goes further to adapt the German scheme to the Chinese corporate structures by making certain amendments. Then, its feasibility in Chinese political, economic, and cultural contexts is tested in Section 6.4, in order to validate the legal transplantation. Admittedly, the company’s resistance, the paternalistic leadership style, and a lack of effective enforcement mechanism for workers, along with other unexpected factors that are unique to China may constitute the obstacle for this legal transplantation. However, it takes time to adapt foreign rules to the domestic context, as argued in section 6.4, the introduction of foreign rules can also exert influences on the domestic environment, making these rules more acceptable. In addition, based on

the implementation of the suggested rules, the party-state reserves the power to further modify these rules to improve their feasibility.

3. Limitations: The Complexity and Unstable Chinese Contexts

By using the approach of ‘legal transplants’, the thesis adapts the German co-determination mechanism to Chinese firms in a prudent way. However, due to the unique complexity of the Chinese context, this thesis cannot exhaustively explore all potential influencing factors on levels of acceptance and the effectiveness of implementation of the introduced German system. Thus, although the thesis projects the feasibility of the suggested rules in the context of China based on observations, it cannot make the arbitrary argument that these rules will definitely be accepted by Chinese legislators and companies or that they will be effective in safeguarding employees’ interests. This is especially the case when the party-state has the decisive say over the direction of economic development, law-making, and the extent of worker protection. The administrative power is characterised as unpredictable and uncertain, and therefore the Chinese contexts are subject to change at any time, potentially rendering the observations on which this thesis makes its arguments invalid.

4. Possible Future Directions: The Reform in a Broader Landscape

The thesis focuses on workers’ claims in the context of takeovers. However, as argued in Chapter 4, German modes of coordination with employees are expected to positively impact the Chinese national economy. In light of this, the question may arise of whether it is feasible and beneficial for Chinese firms to adopt the German coordination mechanism wholesale. This could be expected to change the corporate governance models adopted by Chinese firms as well as industrial relations in China as a whole, in turn leading to the structural reform of Chinese corporate laws and even the entire economic system. Such legal transplantation requires further extensive and thorough examination of the German system’s feasibility in the Chinese context – a scope too ambitious for a doctrinal thesis but deserving of future academic attention.

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